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THE JOURNAL OF Taxation

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January 1958

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THE TAXATION OF INDIVIDUALS

Personal tax problems

EDITED BY BENJAMIN HARROW, J.D., CPA

Technical rules underlying current furor over deductibility of T & E expenses

by ARTHUR I. HEMMINGS

All the current excitement (and dismay) about expense accounts shouldn't obscure the fact that the basic rules haven't changed. Also, that the law, regulations, and IRS policies are what control deductibility in a given case—not statements by individuals nor newspaper headlines. The following analysis tells what the current law is, how it works, what the courts say, and what experienced tax men have found works in practice. For news of the current excitement, see page 6.

PERHAPS NO word in our language has such power to sooth an embattled taxpayer as does the word "deduction." It is equally probable that no other phase of taxation can match the accumulated time and energy expended by the individual taxpayers in securing and protecting this boon. The zeal with which the deduction is pursued is equaled only by the high-bracket taxpayer's search for capital gain situations. As might be expected, the taxpayer rarely understates his deductions, but on the contrary is often found to be somewhat optimistic as to the existence or amount of those claimed on his return. His tax advisor has the unpleasant duty of informing him that some of his cherished deductions are improper or that some will not stand inspection; however, this effect can sometimes be softened by pointing out that he may be entitled to some not claimed.

A substantial deduction for entertainment expenses appearing on the return of any taxpayer can of itself trigger a full-scale controversy with the Service. This is due to two factors. First is the undeniable fact that many abuses, such as making unreasonable estimates of amounts spent for entertainment, and the receiving of disguised compensation or dividends, have been committed by an excessive number of taxpayers. The second factor is the reaction of the Service to these abuses, resulting in an extremely critical attitude as evidenced by the publications of the Service and the "show me" conduct of examination by its agents.

Under the Code the right to a deduction for entertainment expenses is unquestioned. If the expenses are ordinary and necessary and are directly connected with or related to the taxpayer's trade, business or profession, they are deductible.[1] If the expenses are ordinary and necessary and are paid for the production or collection of income, or for the management, conservation or maintenance of income-producing property, they are likewise deductible.[2] Since the right to the deduction is clear, provided that the various conditions set forth in the Code are met, it is apparent that any controversy with the Service must involve the question of compliance with the conditions themselves. This discussion is directed to the area of substantiation of the right to the deduction in view of the current critical attitude of the Service.

IRS policy stiffening

In recent years the Service has through various releases and publications disclosed an increasingly tough attitude toward taxpayers who claim entertainment expenses. In 1952 the Service announced[3] that more attention was to be given in examinations to large entertainment expense deductions, especially those relating to executive expense accounts, executive fringe benefits, lavish entertainment, etc., and indicated that a full substantiation of the claimed expense would be required. Enforcement of the new policy apparently was not satisfactory, due in large part to lack of more specific instructions to the agents. In order to correct this deficiency and supply both agents and taxpayers with a guide to its requirements, the Service issued *Revenue Rulings* 54-195[4] and 54-497.[5] Both of these rulings set forth the degree of substantiation required and *Revenue Ruling* 54-195 further added as a policy that percentage adjustments for settlement purposes were not to be allowed.

Following the issuance of the two above-mentioned rulings a generally tougher attitude on the part of agents was noticed, but apparently not enough to satisfy the top level of the Service. Accordingly, in 1957, a further release[6] by the Service directed its agents to scrutinize expense accounts closely for abuses in deductions of club dues, entertainment, travel, maintenance of yachts, etc.

Coupled with the Service's crackdown on entertainment expense deductions and its policy of requiring allowances to be based on reasonable substantiation, is a third weapon—the imposition of a double tax. The double tax arises when an owner-employee is reimbursed by an employer for entertainment expenses and then a part or all of the deduction is disallowed to the employer for lack of substantiation. The owner-employee then must satisfy the agent that the unsupported deductions did not inure to his personal benefit. Otherwise the agent will attempt to treat the disallowed amount as a dividend, or as other taxable income of an unclassified nature.[7] It is entirely possible that, given a favorable factual situation, the double tax could be avoided by considering the unsubstantiated amounts as additional compensation.[8]

In view of the present Service position, it is only natural to assume that the attitude of the agents on field examinations would reflect the official position. However, such is not the case, and the situation in the field is characterized by a complete lack of uniformity in application. Some agents continue to reach settlements on a percentage basis with little regard for the actual substantiation

presented. Others have adopted rules of thumb as to certain types of expenditures which again bear little relation to the evidence submitted. Still others have gone far beyond the Service's position and have interpreted the directions to mean that certain types of expense, such as yacht maintenance, country club dues, etc., are by their very nature unallowable. Fortunately, the majority of the agents attempt to apply the directions in a reasonable manner. However, the degree to which the lack of uniformity exists does create a serious problem for the tax practitioner It is difficult to explain satisfactorily to a client who has suffered a substantial disallowance, and then discovered that a friend in nearly identical circumstances has suffered only a token disallowance.

In view of the current Service drive against past abuses, we must, of course, do everything in our power to secure the maximum allowances of legitimate entertainment expenses claimed by our clients. In the following paragraphs we will discuss some methods of doing so, particularly with regard to individuals and partnerships.

Importance of proof

Whether an individual operates a sole proprietorship, is a member of a partnership, or is an employee or employee-stockholder, he must be able to prove the amount spent for entertainment, and prove that the amount spent was for ordinary and necessary business purposes.[9] In addition, a partner or employee must also be able to show that the expense was his obligation, and not paid on behalf of the partnership or employer.[10]

The most important condition for securing the deduction is adequate records. This point must be emphasized again and again, even to the point of risking client resentment. Without adequate proof, other factors lose importance, as most if not all of the claimed deduction will be lost.

What are adequate records? There are no clearly defined rules relating to adequate records, but it is certain that a currently maintained diary showing date, amount, nature of entertainment, the persons entertained and their relation to the business, is the minimum acceptable record. Naturally, additional documents such as monthly club statements tied into the diary with personal expenses eliminated, theatre stubs, cancelled checks with proper notations and reconciliation to the diary, etc., all tend to increase the amount of the deduction finally allowed. Unfortunately, many if not most business men consider the maintenance of a diary or other adequate records too bothersome. They tend to rely on estimates, checks drawn to cash without identification as to purpose, club statements, etc., to try to prove by oral argument or persuasion that a substantial amount was spent for entertainment and, therefore, most of the deduction should be allowed under the "*Cohan* case."[11] However, even in those cases where the agent feels that the *Cohan* rule is applicable, he will be trying to allow as little as possible. For a period of time it was felt that if the agent disallowed all of the deduction, the taxpayer could go into court, show that something was probably spent for entertainment and have the court allow a portion of the claimed expense under the *Cohan* rule. However, in a recent case[12] decided in the Fifth Circuit, it was held that because the taxpayer did not present enough evidence as to amounts expended for entertainment, the lower court was justified in ignoring the *Cohan* rule and denying the taxpayer any deduction.

A second condition necessary to secure the deduction is to show that the amounts paid for entertainment were both ordinary and necessary expenses incurred on behalf of the business. Normally, showing that entertainment expenses are ordinary presents little trouble, as the efficient conduct of almost any business requires a certain amount of entertainment. However, showing that the expenditure is necessary presents a more difficult problem, and resolves into the question, "Whom can you entertain?" There is no question but that the entertainment of customers,[13] prospective customers, manufacturers,[14] suppliers,[15] and even purveyors of information,[16] is considered to be necessary, even though some of these persons may also be friends.[17] However, if the entertainment serves no real business purpose it will be disallowed. For example, one-half of the deduction was disallowed to a watch manufacturer and importer who entertained buyers, even though he could not produce enough watches to fill his orders.[18] Similarly, an automobile dealership lost most of its entertainment deduction because of the scarcity of cars during the war years.[19]

The Sutter problem

The *Sutter*[20] case, decided in 1953, raises an additional problem which must be considered in connection with individuals. It is recognized that personal entertainment expenses are never deductible. Prior to the *Sutter* decision it was generally assumed that if an individual paid for a business entertainment function, such as a luncheon for customers, at which he was also present, the entire cost, including his share of the bill, would be a business expense. However, the Tax Court held, in the *Sutter* case, that a portion of the entertainment should be disallowed because it would have been incurred anyway, i.e., the normal cost of the taxpayer's lunch. The court indicated it would require clear and detailed evidence that the expenditure in question was different or in excess of that which would ordinarily have been made by the taxpayer for his personal benefit. For example, under this rule, if you pay $10 for a luncheon for yourself and four customers, you would be entitled to deduct only that portion of the $10 which exceeds the amount you normally would pay for your own lunch. The *Sutter* rule is new and contains many unanswered questions. For example, if you take a client to the theater, would you have to show that you ordinarily never go to the theater,

[1] 1954 Code, Sec. 162(a)
[2] 1954 Code, Sec. 212.
[3] Press Release No. S2079, February 26, 1952.
[4] Rev. Rul. 54-195, 1954-1 CB 47.
[5] Rev. Rul. 54-497, 1954-2 CB 74. This ruling is directed primarily to proof of travel expense deductions, but is equally applicable to entertainment expenses.
[6] IRC No. 57-85, June 20, 1957.
[7] B. F. Crabbe, TCM Dkt. No. 44359, (1956). Marvin T. Blackwell, TCM Dkts. No. 59625, (1956). Max P. Lash, TCM Dkt. No. 48408 (1956); *affirmed* by the First Circuit as to this issue, CA-1, 6/7/57.
The Tax Court stated "A diversion of corporate funds by the dominant stockholder and officer of a corporation has been held to constitute income regardless of whether it may be classified as a dividend, and taxability to him need not turn upon the existence of corporate earnings and profits. Such is the square holding of Davis, 225 F.2d 331."
[8] W. Horace Williams Co., Inc., DC Ln., 7/10/56. The Commissioner sought to disallow an unsubstantiated expense allowance paid to a controlling officer and treat the allowance as additional income to the officer. The court allowed the deduction to the corporation as additional compensation, and taxed the officer on the receipt of additional compensation.
[9] 1954 Code, Secs. 162(a) and 212. The mere opinion of the taxpayer as to the nature of the expense is of little importance, there must be a demonstrable direct relationship between the business and the expense. See Louis Greenspon, 23 TC 138.
[10] Hal E. Roach, 20 BTA 919; Andrew Jergens, 17 TC 806.
[11] George M. Cohan, 39 F.2d 540.
[12] W. H. Williams, CA-5, 7/18/57. This is a companion case to W. Horace Williams, Inc. (Note 8 *supra*).
[13] James F. Coleman, 3 BTA 835.
[14] I. Goldman, 12 BTA 874; Rogers Dairy Co., 14 TC 66.
[15] F. L. Bateman, 34 BTA 351.
[16] Ohio Novelty Co., TCM Dkt. No. 6664 (1947).
[17] Edward R. Fisher Estate, TCM Dkt. No. 26010 (1952).
[18] Jones Schulz, 16 TC 401.
[19] B. F. Curry, TCM Dkt. No. 20129 (1951).

or only that you normally would not have gone to that particular play? If you joined a golf club, would you have to prove that you never would have joined the club except for business reasons, or would you perhaps have to show that you play golf only with clients? It is expected that you will hear much more of the *Sutter* decision during future examinations.

Whose expense?

The third condition for securing an entertainment deduction, and one peculiar to partners and corporate employees, is proof that the expense incurred is that of the individual and not that of the partnership or the corporation. The Service's position is that if an employee pays entertainment expenses which benefit his employer, neither taxpayer gets a deduction unless the employer reimburses the employee. The reason for this position is apparent. If the employee pays the expense he receives no benefit, and the employer which was benefited gets no deduction because it incurred no expense.[21] This same rule applies as between a partner and a partnership. It is quite common for partners to claim entertainment expenses on behalf of the partnership on their individual returns. Although the Service has not raised the issue very often, it is clear that the expenses are not deductible by the individual, unless he paid them by reason of the terms of the partnership agreement. Thus, if the partnership agreement specifically provides that individual partners shall pay partnership entertainment expenses from their own funds, and if it can be shown that the principal purpose of such arrangement is not tax avoidance, the expenditure by the individual partner will be approved by the Service.[22]

In spite of the general rule that an employee may not deduct expenses paid for the benefit of his employer, there are certain circumstances in which he may claim a deduction. The most common of these exceptions is that in which the employment contract specifically defines the type of expense for which the employer will reimburse the employee and the type of expense which the employee is expected to incur on behalf of the employer but at his own cost. While a written employment contract is to be preferred, the taxpayer may still prevail if he can show by use of memoranda or testimony that he is expected as a part of his job, to pay certain entertainment expenses out of his salary.[23] Again, as in the case of proof of the deduction itself, the best proof for this purpose is a clear written record of the arrangement acknowledged in some manner by both the employer and employee. It is probable that unreimbursed entertainment expenses will be disallowed in the future when there is no specific agreement.

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The stockholder-employee

A further problem exists when the employee is also the controlling stockholder of a corporation. It will probably be contended by the Service that a specific employment contract is meaningless because the stockholder would have the power to insist upon reimbursement.[24] However, this position requires the disregard of the separate existence of the corporation, a result which was only recently reversed by the Second Circuit in *Casale* in a different matter, but which reinforced the doctrine of separate entities.[25] Furthermore, such position would be contrary to the theory of *Roach* and subsequent similar cases, which was that the disallowance to the individual arose because there was a presumptive right to reimbursement from the corporation, and not because the individual was a stockholder and could have ordered a reimbursement. If the contract allocating the expense between the corporation and the stockholder-employee is for a reasonable business purpose, and not merely a tax avoidance device, it should be recognized as valid.

The problem of the controlling stockholder can be minimized by the use of a salary plus an expense allowance, provided the total payment does not exceed a reasonable compensation for his services. This will be discussed in the next section.

Advantages of reimbursing

In the foregoing discussion of entertainment expense deductions of individuals there was mentioned the effect on the employee of the reimbursement of these expenses. There was also the suggestion that for the average employee the direct reimbursement method was desirable. We will, in this section, discuss the various methods of handling reimbursements of all types of reimbursable expenses, and elaborate on some of the problems mentioned before.

In all cases in which the employer reimburses an employee, the tax considerations of both the employer and the employee must be reviewed. The ideal reimbursement arrangement is one in which the best possible balance is reached in protecting the deductions of both employer and employee. The employer, naturally, wants a tax deduction for all amounts paid to the employee. Fortunately, except in the case of the controlling stockholder-employee, this usually presents little difficulty, since the payment is either an ordinary and necessary business expense or additional compensation to the employee. On the other hand, the employee faces a number of pitfalls, and the employer must be willing to aid the employee to the extent consistent with its own interest in securing the maximum deduction.

In order to get a deduction the employee must prove that the expenditure was required by the employer as a part of the employment contract, that he was reimbursed for the expense incurred, or that it was necessary in the employer's business. As might be expected, the tax consequences to the employee can vary depending on which reimbursement method is used. Section 62 permits an employee to deduct from gross income in arriving at adjusted gross income, (a) all expenses paid by him under a reimbursement or other expense allowance, (b) travel expenses away from home, (c) transportation expenses. Therefore, if the employee is on a complete reimbursement basis, all of his deductions are in effect deductions against gross income and he will also be able to use the optional standard deduction. Where the employee is on a flat-allowance basis and the allowance is intended to cover all items of deductible expenses, he is still permitted to deduct his expense from

[21] Richard A. Sutter, 21 TC 170.
[21] Hal E. Roach, 20 BTA 919; Andrew Jergen, 17 TC 806.
[22] Reg., Sec. 1-704-1.
[23] Schmedlapp, 96 F.2d 680. The Court stated that "It is no answer to say that they (the entertainment expenses) were for the bank's benefit; so were all the taxpayer's services; if it did in fact give him to understand that he was to extend a factitious hospitality in its interest, the cost of it was a necessary expense of his office." See also Benjamin Abraham, 9 TC 222, and Arthur A. Byerlein, 13 TC 1085.
[24] Horace E. Podenis, 24 TC 21. It should be noted that Podenis worked for an employer (Internal Revenue Service) which had a reimbursement procedure in existence, and the court disallowed only those expenses for which Podenis could have received reimbursement. The expenses not covered by the reimbursement plan were allowed to Podenis.
[25] Oriste Casale, CA-2, 9/5/57, *rev'g* 26 TC No. 131.
[26] Proposed Reg., Sec. 1.62-1(b)(1), and the example shown therein.
[27] B. F. Crabbe, TCM Dkt. No. 44359 (1956-. Marvin T. Blackwell, TCM Dkt. No. 59625 (1956).

gross income and thus use the optional standard deduction if his actual expenses are less than the allowance. If the allowance is less than the actual expenditures, his travel expense away from home and his local transportation expenses are still deductible from gross income. However, his other expenses are deductible from gross income only in an amount which bears the same ratio to the amount of the reimbursement as the total of the other expenses bears to the total expenses.[26] The balance not deductible from gross income becomes a page 2 deduction and this will be lost if the optional standard deduction is used. The individual who is entitled to deduct the expense on the grounds that it is necessary to the production of income, or on the grounds that his employment contract requires him to incur this expense is in a disadvantageous position. He must deduct his expenses (other than transportation and travel away from home) as page 2 items, except in the unlikely event that he can satisfy an agent that his salary must have included an element of expense allowance. He has the further disadvantage that the income tax withholdings and social security deductions will be based on his gross salary.

Obviously the direct reimbursement of the exact amount disclosed by an itemized expense account offers the employee the greatest protection. The questions of who is entitled to the deduction and of the availability of proof, will not arise. Furthermore, the reimbursement will not be subject to withholding, and the employee can use the optional standard deduction without the loss of any reimbursed expense.

Flat allowances

The direct reimbursement offers the greatest protection to the employee, but it also involves a great deal of bookkeeping by the employer. Many employers object to this additional work and the necessity of approving each reimbursement. Accordingly, they provide for the allowance of a flat sum to cover all expenses. The allowance may be in the form of a separate expense allowance check, or it may be included in the regular salary check with a proper classification on the records. In either case, no withholding of income tax or payroll tax is necessary. However, the employer must file an information return, Form 1099, and the employee must include the allowance in gross income and prove the actual expenditures charged against the allowance. Furthermore, as noted above, he may lose a portion of his deduction if his actual expenses are in excess of the allowance and he elects to use the optional standard deduction. One solution for this problem is to designate the allowance as reimbursement for other expenses, such as entertainment, promotion, etc., require the employee to stand his own local transportation expenses, and use the direct reimbursement method for travel expenses incurred away from home.

The third method in which the salary is set to cover expenses, is the simplest from the employer's viewpoint, and is generally used where the employer does not wish to bother with the detailed records of the direct reimbursement method, and where the employee's expenditures are too irregular to use the allowance method. Generally, this is the least satisfactory method from the employee's viewpoint. When it is used, the employer should aid the employee by setting forth in a contract, letter, memo, or in minutes that the salary being paid is expected to cover the employee's expenses.

Again, as in the case of entertainment expenses, additional problems are encountered where the employee is also the controlling stockholder. If such employee uses the direct reinmbursement method and the expense can not be substantiated, not only is the deduction lost to the corporation, but the employee is considered to have received a taxable dividend in the amount of the disallowance.[27] The salary-to-include-expense method is equally subject to attack, as the controlling stockholder-employee would be hard put to show that the expenses were not reimburseable if he wished them to be. Again, as in the case of entertainment expense, and contrary to the general rule, the salary plus a flat allowance for reimbursed expenses seems desirable for controlling stockholders. It has the advantage of preserving the corporate deduction (assuming the total of salary and allowance is reasonable), and if any disallowance is sustained it would be borne by the stockholder-employee for failure to present adequate proof.

Obviously, the necessity for adequate proof is just as important, and takes the same general form, as proof of entertainment expenses discussed above.

In summary, it appears that the following things are necessary to protect the entertainment deduction of the individual:

1. The most important is proof, proof and then more proof. The minimum proof will be a currently maintained diary.

2. In the case of an employee, a written employment contract setting forth in specific terms, what is expected of the employee in the entertainment field, is the most desirable proof. At the least, the employee should have in memorandum form a statement of the policy of the company, or have the terms of his employment covered in adequate detail in the minutes of the corporation.

3. If the employee is also the controlling stockholder of a corporation, it may be desirable to avoid a direct reimbursement plan and thereby prevent the imposition of a double tax on the amount of reimbursed expenses disallowed for lack of substantiation. His contract should call for a salary and expense allowance based on a reasonable estimate of entertainment furnished to the employer, paying for the expenses himself. In this way the deduction to the corporation will be better protected, although the individual will still have to prove his expenses.

4. In every way possible, build up the individual's proof of his right to the deduction as if an attack by the Service is certain—for it's just about sure to come.

Tulane papers to be published

COMPLETE proceedings of the Seventh Tulane Tax Institute, at which Mr. Hemmings presented the paper on which this article is based, held in New Orleans in October, are being published by The Bobbs-Merrill Company, Inc., Indianapolis. Copies are expected in January; the price will probably be around $15.

Expense accounts greatest audit problem in IRS

WHEN ASKED: "What area is causing the greatest difficulty at the present time in the checking and auditing of taxpayers' returns?" Fred C. Scribner, Jr., Assistant Secretary of the Treasury said: "Many areas cause problems, and it is hard to say which one is the greatest. Certainly, one of the greatest is the handling of expense account deductions from gross

income. The statutes and the regulations can establish guidelines for the taxpayer, but in the last analysis such determinations are largely a matter of conscience, of business morality. Here, again, we need the help of responsible tax practitioners.

"The Revenue Service has no disposition to deny honest and legitimate expenses as deductions. It is clearly recognized that in many lines of business, travel and limited entertaining are essential if the business is to continue. But too many taxpayers are building up an expense account economy—spending money and charging it to business purposes—money which they would not think of spending if the tax rates were not as high as they are at the present time. From the many cases of questionable claims that have come to my attention, I am inclined to believe that there are a few businessmen, quite a few businessmen, who would never think of treating a partner or their stockholders the way they treat poor old Uncle Sam.

"The Commissioner is taking note of this problem. In a recent notice which went to all field agents he pointed out that the Service has been taking a close look at expense deductions involving such items as club dues, entertainment, travel, maintenance of automobiles, yachts, and airplanes, maintenance of company-supported residences, branch offices in resort cities, etc." ☆

Action on the expense account front: the IRS attack and the taxpayer's defenses

THE LONG campaign by the Service against expense account padding (and careless recordkeeping on legitimate expenses) culminated recently in two specific IRS directives. These, while they represent no charge in the position the IRS has long taken in theory, will cause an upheaval in taxpayers' normal procedures. We refer, of course, to the new line on Form 1040 requiring details on reimbursed expenses, and to *Revenue Ruling* 57-502 on the burden of proving that the expenses of an employee are his, not his employer's.

Another most critical development has occurred on expenses reimbursed to the owners of close corporations which, though not yet at the stage of public rulings, have been the subject of internal instructions to agents. If these expenses are not substantiated, they are now being treated by many agents as dividends taxable to the officer but not deductible by the corporation.

Item 6(a) on 1040

The box on page 8 contains the rather simple facts about which all the storm has blown up. We have been talking to controllers and tax men in public practice about what their firms are doing and how they are advising clients. We find two points of view:

1. There's no real change; the IRS is going to pay more attention to expense accounts but people who have been well advised in the past and have been following that advice need make no change in their reimbursement and recordkeeping practices. This is by far the majority view.

2. Employees who have received specific reimbursement of disbursements on the submission to the employer of an itemized list supported by receipts, cancelled tickets, etc., must determine the total so reimbursed during the year, include it in income and deduct it on line 6(a). It is among tax men who support this position that you hear the vehement protests against the retroactive feature of the new requirement. Few companies have a recording and filing system that will permit them to determine the totals for each employee without an enormous amount of work by bookkeepers and file clerks.

The fact that the IRS responded to this storm late in November by announcing (IR-206) that line 6(a) may be disregarded on 1957 returns merely gives us time to rearrange our bookkeeping methods so that we will be ready to supply this information next year.

Specific reimbursement v. flat amount

The cause of the difficulty is that the Service makes no distinction between amounts reimbursed for specific payments and round-amount allowances. Some companies have followed the practice of giving employees a flat amount each month, or so much a day while traveling, or so much a mile. Employees receiving this kind of payment have long been aware that they must report the receipt as income and can deduct only the actual expenses they incur. Expenses to the extent of the amount received are deductible on page 1, in arriving at adjusted gross income; any in excess except travel, meals and lodging while away from home can be claimed only if the standard deduction is not used. Taxpayers in this class generally keep their records and are used to the idea of having to produce them to substantiate their claims when the examining agent arrives.

Vastly different has been the usual handling of expenses specifically reimbursed. Many firms have followed the practice of having the employee fill out a petty cash voucher (to which he attaches whatever proof of the expenditure he has) generally on the day the expense was incurred. The firm pays him, the vouchers are filed away and there is no record kept of the total reimbursed to any particular employee. Many firms handle an employee's travel expenses in virtually the same way—the trip report filed on return to the home office is treated as a petty cash voucher.

As we see it, the nub of the controversy over the meaning of the new line 6(a) is: Has the general practice of employees of not including specific reimbursements been incorrect and consequently does the IRS drive mean that erroneous methods must be corrected?

One CPA-attorney in New York who sees nothing to be excited about in the new 6(a) tells us that when his clients call him about the "new" rules he calms them down by telling them to continue their recordkeeping and reporting the way he has been prescribing for years. If the employee submits an itemized list of disbursements, supported by proof, and the employer pays him the exact amount he reports as spent, the employee has had no expense and no income. The expense is the employer's; on it falls the burden of justifying the deduction. These specific reimbursements need not be included by the employee on his return.

On the other hand, an employee who is paid a round-amount allowance must report the receipt on his return and must itemize his expenditures and be prepared to justify them to the IRS. But, our CPA adds, "I've been telling just that to my clients for years and most of them who have round-amount allowances have been examined at one time or another and are aware of the importance of keeping their records.

Line 6(a) means nothing new to them—the items will go on the face of the return instead of on a schedule attached. That's all."

It is unfortunate that the Regulations don't make a clear distinction between these two vastly different situations. There is logical support for the differing ways taxpayers generally have treated them. For example, Montgomery's "Federal Taxes," 36th Edition, simply says flatly: "If expenses are incurred on behalf of another, in connection with the taxpayer's trade or business or employment under an understanding or agreement that the expenditures will be reimbursed, neither the original expenditures nor the subsequent repayment have any effect on the payer's income. Such a transaction is capital in nature, being merely a loan or advance and repayment thereof. However, reimbursement of an employee's purely personal expenses by an employer constitutes taxable income to the employee. When an employee is given an expense allowance and no accounting is rendered to the employer, such amounts must be included in the employee's gross income. The employee is allowed a deduction for the actual amount of incurred expenses."

Exactly, reply those who insist every reimbursed expense must be reported. See how Montgomery says that reimbursed personal expenses are income. The mere fact of specific reimbursement can't justify omitting the item from the employee's return. Suppose the employee is reimbursed to the penny for what is really not a deductible business expense—as, for example, the expense of a personal vacation trip treated by the employer as a convention? This is just the kind of thing the IRS wants to get a look at; it doesn't make sense to define reimbursed expense as used on Form 1040 in such a way as to exclude every specific reimbursement. True, the IRS has been lax about this in the past; they were inclined to believe that they could rely on the employer policing detailed expense accountings. Now they know they can't rely on it; the employer (particularly when it is a corporation owned by the employee) is frequently perfectly willing to pay expenses rather than salary.

The plain fact is that the IRS does draw no distinction between flat round-amount allowances and specific reimbursement. Both must be accounted for in the same way and the IRS is serving notice that it is not going to overlook omissions any longer. Nor does this mean that if the office boy is sent out for a ball of twine and he pays for it himself and then puts in a petty cash slip that he has to report the receipt and disbursement. The true test, say tax men we have interviewed, is whether or not the service or commodity purchased was actually used by the employee. The twine here is not his expense; he is not getting the use of the twine. The man who rides in the plane, sleeps in the hotel, eats the meal, sees the play, uses the country club is the one who has the expense, which is reimbursed, and he must report the payment he receives for it regardless of the bookkeeping details.

The IRS got into just such a tangle in its rules over reporting expense allowances on Form 1099. Back in 1945 it issued TD 5480—return of information as to payments to employees. The TD said that amounts paid to employees as compensation which were not wages subject to withholding reported on W-2 must be reported on Form 1099. The TD continued: "For example, if . . . payments made to an employee by his employer in 1945 amount to $600, and $400 thereof represent wages subject to withholding . . . and the remaining $200 represent compensation not subject to withholding, for instance advances or reimbursements for travelling or other expenses . . . the $400 must be reported on Form W-2 and the $200 must be reported on Form 1099."

About six weeks later the Treasury issued Mim. 5947: Inquiry has been made as to the scope of that part of Treasury Decision 5480 . . . which provides that "compensation not subject to withholding, for instance, advances or reimbursements for traveling or other expenses" is to be reported on Form 1099 if the wages subject to withholding and such advances or reimbursement total $500 or more for the calendar year . . . The advances or reimbursements for expenses contemplated by Treasury Decision 5480 are those which are made by the employer without requiring an accounting by the employee to the employer that the expenses are ordinary and necessary expenses incurred in the business of the employer. The Bureau will consider that the employer has complied with the provisions of the Treasury Decision if advances or reimbursements for expenses to be reported on Form 1099 are confined to those with respect to which the employer does not require the employee to submit expense accounts showing that the advances or reimbursements are ordinary and necessary expenses of the employer's business.

The Lap of Deductible Luxury

"The expense account—its wry pleasures, its hangovers, its bonanzas and its abuses—has become one of the uneasy national jokes of our time. We have built it firmly into our economy as a method of salesmanship, even though we are not always at all sure just how effective caviar and champagne may be in the conduct of a business. But further than that, it has become one of the greenest of playing fields for that all-American exercise in sportsmanship, getting around the income tax."—Russell Lynes in *The New York Times Magazine.*

What to do

There is no argument but that the round-amount allowances are to be reported as in the past, but now on the return itself. How about specific reimbursements? We've run into no controllers who are planning to furnish all employees with a statement of total reimbursements to them. Some of them say they will do it if the employee asks for it.

The IRS authorization to ignore 6(a) for 1957 gives time to explore the ramifications of the Treasury position. The article by Arthur Hennings on page 2 of this issue will help you choose the best method of handling expenses for stockholders and nonstockholder-employees. If the Treasury refuses to make the distinction it made in 1945 between flat allowances and specific reimbursements, then we expect to see accounting methods developed (perhaps by photoprints of bills and other supporting evidence) so that both the employer and the employee will have easily accessible both the total amounts paid to particular employees and the proof of the payment by the employee.

Your editors will be reporting developments in this area in the coming months.

Pay expenses directly

For the future, the obvious solution is for the firm to pay as many expenses

THIS IS WHAT THE LAW SAYS ABOUT EXPENSE ACCOUNTS

SECTION 62 of the Code defines adjusted gross income in the case of an employee (other than an outside salesman) as consisting of gross income less "(2) trade and business deductions of employees—(A) Reimbursed expenses—The deductions . . . which consist of expenses paid or incurred by the taxpayer, in connection with the performance by him of services as an employee, either under a reimbursement or other expense allowance arrangement with his employer; (B) Expenses for travel away from home—The deductions . . . which consist of expenses of travel, meals, and lodging while away from home, paid or incurred by the taxpayer in connection with the performance by him of services as an employee; (C) Transportation expenses—The deductions . . . which consist of expenses of transportation paid or incurred by the taxpayer in connection with his performance by him of services as an employee."

The new form

Form 1040 (individual income tax return) for 1957 contains a new line, 6(a). Line 5, as in prior years, calls for all wages, salaries, bonuses, commissions, tips and other compensation. 6(a) calls for the deduction of "Travel, reimbursed expenses."

The unchanged instructions

The Treasury said, in IR-204, that "the addition of line 6(a) does not mean that there has been any modification of the policy which the Revenue Service has followed for several years with regard to the substantiation of expenses claimed as a deduction. No more detailed records will be required for 1957 than have been needed in the past. In fact, the instructions on expense accounts for 1957 are identical with those issued in 1954, 1955 and 1956.

"The new line will enable the Service to give attention to those returns where deductions for expenses appear to be disproportionate in relation to the employee's income and occupation, and thus aid in detection of abuses that have arisen in this area.

"In the examination of individual tax returns for 1957 the Revenue Service will concentrate on major abuses in the expense account area and no requirement of unreasonably detailed records is intended."

While the IRS has now announced that taxpayers may ignore line 6(a) for 1957, the instructions prepared for the 1947 return will tell us what will be required in 1958.

The instructions for the 1957 return say "Line 6(a)—travel, reimbursed expenses other than for travel and transportation—If your employer pays you an 'expense account' or otherwise reimburses you for money spent for him in connection with your employment (other than 'travel and transportation'), you should add these payments to your wages on line 5, and then on line 6(a) subtract the total of your actual allowable expenses of this type but not more than the reimbursements. Attach a detailed statement in explanation. Any allowable expense in excess of the reimbursed amount may be deducted as 'Other Deductions' on page 2 of your return if you itemize your deductions.

"Out-of-town travel expenses—The law provides special deductions for the expenses of travel while away from home in connection with your employer's business. . . . Travel expenses do not include any entertainment expenses or any personal expenses such as laundry. Any amount paid to you to cover these expenses must be included in your wages. You can deduct your full 'travel expenses' on line 6(a). Attach a statement to your return explaining in detail the expenses you deduct. . . .

"Other transportation expenses—Even though you do not travel away from home, as explained above, you may deduct transportation expenses paid in connection with the performance of services for your employer on line 6(a). . . . Any reimbursement of these expenses must be included in your income. Attach a statement to your return explaining in detail the expenses you deduct. . . .

"Expenses of outside salesmen—The law allows 'Outside Salesmen' to deduct all their ordinary and necessary business expenses. Such expenses should be deducted on line 6(a). This applies only to full-time salesmen who are engaged in soliciting business for their employers away from their employer's place of business. . . .

"Other expenses of employees—The expenses set forth above are the only ones which may be deducted from salaries and wages on page 1 of Form 1040 by employees. . . ." ☆

as it can directly. We foresee a further increase in credit card systems. The more travel and entertainment that can be billed directly to the company the less will have to be reimbursed and accounted for by the employee.

Despite the uncertainty in how it should be reported, a reimbursement system has the advantage of being some evidence that the expense is truly a business item and not merely personal. In addition, the IRS noted in its recent *Revenue Ruling* 57-502 that reimbursement is some indication that the expense was necessary in fulfilling the employee's office. This ruling reviewed at some length the cases in which the issue was whether the expense is deductible by the employee who claimed it or should be allowed only to the corporation. The ruling concluded that "a corporate officer who claims deductions for traveling and entertainment expenses incurred on behalf of a corporation must bear the burden of proof that he is entitled to this deduction on his own return.

Reimbursement for such expenses to the corporation officer or at the least a resolution requiring the assomption of such expenses by him would tend to indicate that they are a necessary expense of his office. Although the presence of such evidence does not conclusively determine that the expenses are deductible, neither does the absence of such evidence of itself necessarily result in the disallowance of deductions, provided it can be established otherwise that the expenses are a necessary expense of the office."

Dealings not at arm's length

Thus far we have been talking about the troubles that face an employee who

is not a stockholder or related to a stockholder. If he can't substantiate his expenses he has additional taxable income. The tax situation of the employer is usually unaffected—the amounts it paid are either expenses as listed or additional compensation to the employee. And the problem of unreasonable salary does not plague the unrelated employee.

But when the employee is also a stockholder there is a grave hazard that the unsubstantiated expense will be treated as a dividend—taxable to the recipient but not deductible by the corporate employer. From conversations with tax practitioners in various areas we have gathered that agents are taking a very rigid attitude on this. They are refusing to allow unsubstantiated expenses to be treated retroactively as loans to the stockholders or as additional compensation, even when there is no question of reasonableness. The double tax involved can be so high (if the corporation pays 52% and the individual 50%, the tax involved is more than the unsubstantiated deduction) we can expect to see litigation. In the meantime, firms that have been allowing expense accounts as a source of tax-free income to their owners are undoubtedly facing serious trouble. They are risking a double tax.

Necessary but unprovable expenses

This tightening up on substantiation of expenses makes even more difficult the situation of firms who are forced, or at least think they are forced, to make hidden payments or face grave business difficulties. These range from outright illegal protection to underworld characters to various deals and profit-splitting. In some industries and in some foreign countries the amounts involved can be huge—and of course they cannot be substantiated. The payments must be in cash and no receipts are given! We have been told of cases in which agents are treating such disbursements as dividend income to the employee-stockholder. Certainly the stockholder is in difficulty if checks were drawn to and cashed by him. Where the funds cannot be directly so traced, there is usually only one tax assessed—corporate tax on disallowance of the payment as an expense.

Probably none of the taxpayers now caught by the Treasury's sterner policy was unwarned. Tax men have been saying for years that looseness in handling expense accounts is dangerous. But for a long time there was a good chance that the examining agent would be superficial and accept a "reasonable" percentage disallowance. Those days seem to be gone. There is too much evidence that all ranks of the IRS from the Commissioner down to the examining agent are going to adopt a tough "show me" attitude. Undoubtedly the pressure for this new policy is the widespread public idea that businessmen have been getting away with murder.

And, in conclusion, we suspect that the IRS reaction to all the furor over 6(a) is "we're hitting pay dirt now." ☆

New decisions affecting individuals

Corporate resolution, or reimbursement, will help employee get his T and E deduction. A corporate officer claiming a deduction for expenses must prove the expense required by the job. The IRS rules that reimbursement from the employer, or a corporate resolution requiring the officer to assume the expenses, would be some evidence they are necessary expenses of his office. However, such evidence would not conclusively determine that the expenses are deductible nor does absence of such evidence preclude their deduction. *Rev. Rul.* 57-502.

Race track employee entitled to traveling expenses; was away from home. Taxpayer, a pari-mutual calculator, lived in Louisville, Ky., and worked at the Churchill Downs race track in Louisville 38 days each year, the full racing season. For the remainder of the year he negotiated with track officials who came to Louisville for the racing season, to work at three or four different race tracks around the country. The court concludes that his home was in Louisville, and that he is entitled to deduct travel and living expenses at other tracks because he was away from home in pursuit of trade or business. *Weidekamp,* 29 TC No. 3.

Auto expenses for transporting tools; deductible costs of temporary "home" near employment disallowed. Taxpayer cut trees and sawed them into logs at a stated amount per thousand feet, used his auto to travel between his home and the areas where he worked, and to carry tools and equipment. He is permitted a deduction for the cost of transporting the tools and equipment, but is denied any deduction for commuting to the various areas. The taxpayer also rented a shack near the area during the winter months and the wet season when roads were impassible. The court holds that amounts spent for rent, and incidental expenses connected with use of the shack are denied under the test of *Flowers* (326 U.S. 465). Taxpayer was not required by his employment to live at the shack. *Allenby* TCM 1957-207.

No deduction for transportation to work. Expenses incurred by a railroad brakeman to travel between his home and place of employment are held to be nondeductible personal expenses even though there was no public transportation between his home and work, and he was unable to find suitable living quarters nearby. *Atkinson,* TCM 1957-191.

Auto expenses for commuting not deductible. Taxpayer used his auto in going to and from work because public transportation was not available. Nor were living accommodations for the taxpayer and his family available at or near the place of employment. The court holds no part of the auto expenses deductible as business expenses. In his reply brief, taxpayer took the position that one-half of the use of the auto was for travel by taxpayer's wife to obtain medical treatment and that he could therefore claim a medical deduction. The court refused to consider the issue since it was not raised in the original pleadings. *Daniels,* TCM 1957-209.

Truck driver's meals on daily run not incurred while "away from home." A truck driver made 280 turn-around trips during the taxable year from Ocala, Fla., to Valdosta, Ga., each trip lasting about 14 hours. The fact that his regular working day included a portion of two days or that during his runs he ate all three meals in restaurants is not considered sufficient justification for the deduction of the cost of meals. The court holds the expenses were not incurred "away from home." *Herrin,* 28 TC No. 155.

Living and travel expenses on out-of-town construction jobs deductible [*Non-*

acquiescence]. Taxpayers were construction workers who worked at various job sites both near their home and at distant points. They were permitted to deduct living expenses and transportation costs at jobs away from home for periods of 8 to 20 months. The court, though recognizing the particular job assignments as "temporary," refuses to adopt a flat rule that employment on *any* construction project is "temporary." *Peurifoy*, 27 TC No. 149, *nonacq.* IRB 1957-33.

Appeal from divorce decree does not affect divorce status at end of year. Taxpayer was divorced from his wife in 1951 under a Maryland decree *a mensa et thoro*. They both filed appeals before the end of the year. The lower court's decree was not affirmed until April 1952. The court finds the appeal did not vacate or annul the decree as of the end of the year before affirmance by the appellate court. Therefore, taxpayer and his wife were not entitled to file a joint return for 1951, nor could taxpayer claim an exemption for her on his separate return. *Sullivan*, 29 TC No. 10.

Husband can't use his former wife's estimated tax payments. A husband and his former wife agreed to file separate returns and to split their community income for 1951, the year in which they were divorced. The wife also agreed to "reimburse" the husband for any amounts of additional tax which might result from the inclusion in his return of such community income. The Tax Court held that there was no marital community in existence and that the husband, who had remarried in 1951, could not report half of his former wife's income. Accordingly, he was not permitted in filing a 1951 point return with his second wife to claim a credit against his tax for estimated tax payments made by the former wife whether before or after the divorce. This court affirms. *Gooding*, D. C. Cir., 11/7/57.

Periodic payments to end before ten years not taxable alimony. On February 13, taxpayer and her husband entered into a separation agreement which was attached to but not incorporated in a divorce decree entered on February 16. This court affirms the Tax Court finding that the payments were pursuant to the divorce decree rather than the separation agreement. The principal sum provided in the agreement was to be paid within ten years from February 13. Since this period was less than ten years from the date of divorce, the payment was not a periodic payment and was not taxable to the wife. [Under the 1954 Code, the ten-year period starts from the date of the agreement.—*Ed.*] *Newman*, CA-8, 10/17/57.

Father denied dependency exemption for children living with divorced wife. A father, whose two children were in the custody of his divorced wife, paid $680 toward their support. The court finds that the mother and her second husband advanced over $1400, or more than 50% of the children's support, thereby entitling her rather than the father to claim the children as dependents. *Hastings*, TCM 1957-202.

Father denied dependency credit for child living nine months with ex-wife. Taxpayer paid his former wife $8.50 per week for the support of his son during the nine months when the son lived with her, and paid for his son's support during the three summer months when the child lived with him. However, the court holds he is not entitled to the dependency credit in the absence of proof that the amounts he spent were over half of the total cost of support. *Twohig*, TCM 1957-195.

Father denied dependency deduction for minor son living with divorced wife. Taxpayer is held not entitled to a dependency deduction for a minor child residing with its divorced mother during the taxable year; he failed to establish in any manner the total amount expended for the child's support. *Jacquillard*, TCM 1957-200.

Donee can deduct legal fees in gift tax controversy. Taxpayer's mother made him a gift of securities; he retained an attorney to contest the Government's valuation of the securities in computing his mother's gift tax liability. The court notes that taxpayer's interest in this valuation is clearly shown by (1) his contingent liability for the tax if the donor does not pay, (2) the tax lien on the securities in his hands, and (3) his concern over possible estate tax valuation problems for similar securities he owned. Taxpayer is allowed a deduction for this legal fee as an ordinary and necessary expense in connection with the determination, collection or refund of any tax under Section 212(3) of the 1954 Code. The court notes, however, that it is not an ordinary or necessary expense incurred for management, conservation, or maintenance of property held for the production of income. *Bonnyman*, DC Tenn., 9/4/57.

Farm operation considered a business rather than a hobby. Taxpayer was a low-salaried employee of duPont about to be retired. He acquired a poultry farm to supplement his retirement income. Even though the farm was used as a residence for himself and the families of two of his children, the court concludes from the facts that the farm was being operated for profit and not merely as a hobby. Losses of about $1,000 a year sustained during the farm operation are therefore allowed as having been incurred in a trade or business. *Farrow, Sr.*, TCM 1957-188.

Payments under threat to "racket" men nondeductible. Taxpayer, an attorney, held certain funds in escrow on behalf of clients whom he described as being in the "rackets." In accordance with the escrow agreement, he paid over the escrow funds to a vendor of combination phonograph slot machines. When the vendor absconded with the machines the attorney repaid his clients out of his own funds after they "threatened" him. The court denies a deduction for the repayment holding it to be a personal expense not related or incidental to the attorney's trade. *O'Neill*, TCM 1957-193.

Stockholder's country club dues not deductible by corporation. Taxpayer-corporation is not permitted to deduct a payment for country club dues of its principal stockholder; there was no evidence that the stockholder entertained customers although she did use the club occasionally to entertain the corporation's personnel. The court notes that the evidence of business use is meager and that use to entertain company personnel was probably more for personal satisfaction than to aid business. *Western Products Co.*, 28 TC No. 143.

Can deduct part of expenses for cabin cruiser used to entertain customers. An auto dealer maintained a 42-foot cabin cruiser which he used partly for entertaining customers and partly for personal recreation. Applying the *Cohan* rule, the court allows as a business expense about a third of the claimed expenses incurred in operating and in-

suring the boat. *Kilborn,* 29 TC No. 14.

Teacher allowed graduate school expenses to maintain position. Expenses incurred by a school teacher, who was required to attend graduate summer school in order to maintain her senior salary status, are deductible even though the courses were also used to earn a master's degree. *Green,* 28 TC No. 135.

Attorney fees for gift tax contest not deductible. [***Old Law***]. Under the 1939 Code, there was no specific provision allowing deduction of legal fees incurred in a gift tax controversy. Taxpayer here argued she should be allowed the deduction as an expense incurred for the production of income. As part of a separation agreement taxpayer received certain funds plus a sum held in escrow to go to her if there should be no gift tax on the whole transfer; otherwise, the tax would be paid from it. After litigation, it was held that there was no gift tax liability. The court holds that the taxpayer may not deduct the attorney fees incurred. Taxpayer never "held" the escrow for the production of income. [Under the 1954 Code, deduction is permitted for costs of determination of any tax.—*Ed.*] *Sturgeon,* DC N. Y., 10/15/57.

Capital gain deduction not part of hobby loss. The 50% deduction of the excess of net long-term capital gain over net short-term capital loss does not constitute a deduction attributable to a trade or business for purposes of Section 270. That section places a limit on business deductions allowable to individuals where such deductions for each of five successive years exceed gross business income by more than $50,000. *Rev. Rul.* 57-527.

New Hampshire Tobacco Tax deductible. Effective 7/14/55, the New Hampshire tax on tobacco products is deductible by the consumer if he itemizes his deductions. *Rev. Rul.* 57-486.

Wife liable for tax on husband's partnership income by virtue of community property rights. Taxpayer and her husband, residents of California and members of the marital community, entered into a property settlement agreement under which taxpayer waived all her rights to her husband's interest in a partnership except to the extent of $117,500, his capital account as of 2/28/51. When the Commissioner later determined that the partnership had additional profit for the year ended 2/28/51, he sought to tax taxpayer upon one half of her husband's additional income notwithstanding the settlement agreement. The court agreed, pointing out that although taxpayer effectively made her husband the transferee of income which under the community property laws belonged to her, she could not shift the tax. *Hubner,* 28 TC No. 134.

Fire and break-in loss disallowed for failure of proof. Taxpayer's house was broken into on several occasions, resulting in indeterminate damages. On one occasion a barometer costing $125 was stolen. Forest fires also damaged a stand of pine timber. Taxpayer had claimed a total loss of $1,000 but the court allowed only $125 for the theft of the barometer. It disallowed the balance for failure to prove the value of the property before and after the fires and break-ins. *Little,* TCM 1957-204.

Shrubbery destroyed isn't measure of hurricane loss; must show loss of value of entire estate. As a result of a tropical hurricane ornamental trees and shrubs having a fair market value of $2,000 were destroyed on taxpayer's Palm Beach estate. Since no evidence was offered of the difference in value of the estate before and after the casualty, the court allows as a loss only $400, the expenses incurred in removal of the debris. *Western Products Co.,* 28 TC No. 143.

Retirement income to be reduced by proceeds of NSLI insurance. The Code requires that the retirement credit of $1,200 allowed taxpayers over 65 for certain types of income must be reduced by, among other items, a nontaxable pension. Accordingly, in computing his retirement income credit, a veteran over 65 must reduce the maximum retirement income of $1,200 by the excess of nontaxable monthly installments received during the taxable year from a matured U. S. Government life insurance endowment contract over the portion of such total amount which is attributable to the investment in the contract. *Rev. Rul.* 57-504.

Trustees of industry vacation fund must pay IT withholding, employer SS and FICA. Under an agreement between a union and an employers' association, the employers turn over a percentage of payroll to trustees as a vacation fund for eligible employees. The Service rules that the trustees as the persons having control of the payment are under the withholding regulations responsible for withholding. Under social security and Federal unemployment rules however, the person for whom the services are performed is liable for the tax and withholding. The tax is due when the payment is made to the employee—not when the assessment is paid to the trustees. *Rev. Rul.* 57-316.

Dividend credit not reduced if alternative gain tax is used; Regulation invalid. The controversial Treasury Regulation Section 1.34-2 is here declared invalid. This Regulation required that a taxpayer paying the alternative tax on capital gains must compute his dividend received maximum as 4% of taxable income, reduced by 50% of capital gains. The court, in declaring the Regulation in direct conflict with the Code, points out that the alternative tax provision does not redefine taxable income. Regardless of the method employed in computing tax, the dividend credit limitation is 4% of taxable income as defined in the Code, which definition includes all capital gain. *Springs,* DC S. C., 8/5/57.

SS tax for ill wife's nurse a medical expense. A taxpayer, whose wife is a bed patient at home and requires the constant attention of a nurse, may deduct as a medical expense the social security taxes paid as employer on the nurse's wages. *Rev. Rul.* 57-489.

"Seeing-eye" dog expenses are medical, not business expenses. Amounts paid by a blind individual for food, innoculations, and other expenses connected with the maintenance of a seeing-eye dog used daily in the conduct of his business are classified as medical expenses (allowable only if deductions are itemized, subject to the percentage-of-income and maximum limitations), and are not in any event deductible as business expenses (a deduction from gross income for an entrepreneur or partner). The IRS maintains the position it took in *Rev. Rul.* 55-261, that the cost of maintaining a seeing-eye dog is incurred for the alleviation of a physical defect. It cites *Bakewell* (23 TC 803), in which a lawyer was denied the cost of maintaining a hearing aid as a business expense. *Rev. Rul.* 57-461.

TAX CONSEQUENCES OF

Corporate organization and distributions

EDITED BY RICHARD L. GREENE, LL.B.

Prunier reversed: no income to stockholders from premiums paid by corporation

by **ROBERT J. LAWTHERS**

Usefulness of insurance in corporate buy-out and business continuation plans becomes vastly greater, now that the First Circuit has held premiums paid by the corporation on insurance bought to fund such a plan are not dividends to the stockholders. Details of the government's and taxpayer's briefs in the Prunier case,[1] analyzed here, reveal significant points for future planning to minimize taxes.

THE PRUNIER BROTHERS of Worcester, Mass. had caused their corporation to pay premiums on insurance policies on their lives, naming themselves as beneficiaries and owners. If the terms of the policies had controlled the property interests therein, each premium payment would, without question, have constituted taxable income to one or the other of the brothers.[2] However, entries had been made on the minute books of the corporation to the effect that at the death of an insured, the proceeds of the policies on his life would "go to the corporation," to be used by it to buy out the interest of the decedent.

The corporation did not claim any deduction for the premiums it paid, but included the amount in Schedule M of its return as "Insurance premiums paid on the life of any officer or employee where the corporation is directly or indirectly a beneficiary."

The Commissioner had assessed the brothers with income tax liability for the premiums for the year 1950, and the Tax Court upheld him. The reasons assigned were mixed, varied, overlapping and somewhat conflicting, without much in the way of discrimination as to their respective importance.[3]

The issues

As the case reached the circuit court, there were several possible issues, among which were the following. Were the policies, during the life of an insured, and the proceeds at death, general corporate assets, reachable by creditors of the corporation? Was the whole arrangement, with its peculiar set of facts, more like a provision for purchase and sale between stockholders, individually, than a provision for a corporation buyout? In general, do corporate redemptions of stock, or agreements to effect them, sufficiently fulfill business purposes, or are they so devoid of such purposes as to constitute a use of corporations for stockholder ends?

The Tax Court had not really faced up to the primary issue of the ownership of the policies—perhaps because it had embarked on such uncharted seas that it had become unable to realize the primacy of this issue. Witness its *Casale* decision![4] As the dissenting opinion says, it is difficult to determine exactly what the court did find respecting the beneficiary and ownership of the insurance.

My own guess is that it saw the situation as similar to that of *Bonwit*[5] (in which policies, paid for by a corporation, irrevocably named objects of the insured's bounty as beneficiaries, without specific reservation of ownership rights to anyone), viewing the Prunier policies as effectively insulated from general corporate use during the life of an insured, and considering the use of the proceeds at death to buy out the decedent's stock as benefitting the shareholders to the exclusion of the corporation. In the light of this court's subsequent *Holsey* decision,[6] with its sweeping generalities, I now find it difficult to determine whether this was because of the peculiar combination of facts in the *Prunier* situation, or because of a position that, in general, corporate redemptions of stock benefit solely the stockholders.

The taxpayers' brief

The taxpayers' brief, on the appeal, hammered magnificently on all fronts. It marshalled Massachusetts cases and persuasive arguments to the effect that, live or die, the policies and their proceeds were assets of the corporation and could have been reached in equity, and that whatever benefits the brothers might have derived from the premium payments were conditional. It emphasized the possible use of the policies, during the life of an insured, or the proceeds, after his death, to satisfy the claims of creditors.

The brief argued that the situation was to be viewed as though a conventional type of buyout agreement had been entered into between the corporation and the shareholders, and the corporation had acquired the policies as general corporate assets, to potentially, but only tentatively, assist it in fulfilling the agreement.

It carried the war into the enemy's camp by attributing to the Commissioner and the Tax Court an attempt to reinstate a defunct heresy that, in general, there is no business purpose in agreements for corporations to buy their stock, but only a use of corporations to accomplish personal objectives of shareholders. It referred to the attempt of the Tax Court at this in 1950, and the rout it had suffered in the Third Circuit's *Emeloid* decision.[7]

The Government's brief

The brief for the Government was a worthy companion to the origins of the case. Although it should have been obvious that the very foundations of the Government's claim rested upon the policies not being a general corporate asset—and that this could not be controlled otherwise than by Massachusetts law—the brief made no attempt to distinguish the facts from those of the Massachusetts cases cited by the taxpayers.

One sentence of the brief was devoted to answering four pages of taxpayer argument—and that is a sentence of such

ineptitude that it cries for quotation. "Clearly, however, the taxability of the premiums to the brothers as income under Section 22 (a), Internal Revenue Code of 1939, is governed by Federal law and not by state law, and the settled principle is that the premium payments are taxable to the one who controls or receives the benefit of the payments."

Could there have been this apparent degree of unawareness that just what was at stake was a determination of "the one who controls or receives the benefit of the payments," and that this could not be determined but in harmony with Massachusetts law? If the Government's case was not already lost, that sentence lost it!

The Government's brief followed the example of the Tax Court in ignoring the problem of the ownership of the policies during the life of the insured. With respect to the use of proceeds at the death of an insured, it vacillated between a position that the special circumstances of this case assimilated the arrangements to a diversion of corporate funds to implement an individual-buy-out arrangement, and a position that, in general, stockholder rather than corporate purposes are served by stock redemptions.

The circuit court's decision

The meat of the First Circuit's decision is contained in two paragraphs:

"We do not understand that the majority of the Tax Court reached the conclusion they did on any motion (sic) of 'disregarding the corporate fiction.' Human beings take advantage of laws permitting incorporation because they think it will be economically advantageous to them individually. That is so whether the corporation is a 'closely held' company owned by two stockholders, or one having 2,000 stockholders. In a loose manner of speaking, it can be said that any corporate gain is a benefit, indirectly, to the stockholders, so that if a corporation becomes the beneficial owner of insurance policies, the stockholders receive the benefit thereof. Of course this argument proves too much, for it would lead to the conclusion that profits made by a corporation in its business are automatically taxable income to the stockholders. This is contrary to the taxation scheme of the Internal Revenue Code. And the Government is only contending in this case that it was the payment of premiums by the corporation which constituted income to the insured employees and stockholders, which in itself is a recognition of the corporation as a separate legal entity. . . .

"In the present case the Government has not made any real effort to controvert the argument that under the Massachusetts decisions a court of equity would treat the corporation as the equitable owner of the policies of insurance. That being so, and having in mind the statutory scheme whereby the corporation J. S. Prunier & Sons, Inc., is dealt with as a separate legal entity and a separate taxable unit, and disregarding the loose sense in which it could be said that a benefit to J. S. Prunier & Sons, Inc., is a benefit to its controlling stockholders, it is sufficiently evident that the payment of premiums by the corporation in 1950 did not constitute, in that taxable year, reportable income to Henry and Joseph Prunier. See generally, *Casale*, 247 F.2d 440 (CA-2, 1957). What will happen when one of the brothers dies is not before us."

Thus, it having been determined that the corporation owned the policies and that the policies had not been insulated from availability to creditors, if needed, we have, from this point on, the identical questions of law that were involved in *Casale*.[8] Both cases involved a payment of life insurance premiums by a corporation in connection with arrangements that *could* be evaluated as a sham or as benefitting a shareholder rather than the corporation. *Casale* did not involve the question of determining the legal or equitable owner of the insurance, because in that case the corporation clearly possessed every property right in the policy.

In both decisions, we have a reaffirmation of the following principles, which are so fundamental and so completely settled they should have needed no reaffirming.[9]

Unless a corporation itself is a sham, there cannot be a corporate distribution, actual, constructive or economic-benefit, when the corporation acquires an asset which remains available for general corporate use—and no more so with respect to a life insurance policy than with respect to any other form of property.

More from the opinion

Just as in *Casale* the Second Circuit saw no need to determine the good faith or sham of Casale's deferred compensation arrangements with his corporation, or to expatiate upon possible tax results of the consequent accumulation of earnings or of distributions by the corporation *when they should be effected*, so in *Prunier* the First Circuit saw no need to decide respecting the broader issues of corporate redemptions of stock or agreements to effect them. However, the court does give some indication of its attitude toward such matters, *in general*.

"Certainly the fact that the corporation may have been contractually bound to apply any proceeds of the policies, had they matured in 1950, to buy out the stock interest of a deceased stockholder, does not mean that the corporation would not have been 'enriched' by collecting the face amount of the policies. All that would then have been involved would have been a change in the form of the assets from cash to

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[1] Henry E. Prunier et al., 28 TC 19; *rev'd* CA-1, 11/8/57, Docket No. 5280.

[2] Casper Ranger Construction Co., 1 BTA 942 (1925); George M. Adams, 18 BTA 381 (1929); N. Loring Danforth, 18 BTA 1221 (1930); Frank D. Yuengling, 69 F.2d 971 (3rd Cir. 1934), *aff'g* 27 BTA 782; Paramount-Richards Theatres, Inc., 153 F.2d 602 (5th Cir. 1946), *aff'g* TCM 806; C. Francis Weeks, 16 TC 248 (1951).

[3] See: Mannheimer and Friedman, *Stock Retirement Agreements—The Prunier and Sanders Decisions*, 35 TAXES 567 (August, 1957); and Lawthers, *Prunier offers no threat to a sound insured buyout plan*, 7 JTAX 2 (July, 1957).

[4] Oreste Casale, 26 TC 1020 (9/12/56); *rev'd*, see Note 8 *infra*. See Lawthers, *Weakness in Casale decision*, 5 JTAX 342 (Dec., 1956).

[5] Bonwit, 87 F.2d 764 (2nd Cir. 1937), *aff'g in part and rev'g in part* Paul J. Bonwit, 33 BTA 507, *cert. den.* 302 U.S. 694. See Lawthers, Note 6 *infra*.

[6] Joseph R. Holsey et ux., 28 TC No. 107 (8/8/57.) See Springer, *New Tax Court policy*, 7 JTAX 269 (November, 1957). For a detailed discussion and evaluation of this and all the other recent cases (and some older ones) on premium payments on life insurance and on stock redemptions, with recommendations, see Lawthers, *The Fragile Bark of the Small Corporation*, C.L.U. JL., Vol. XII, No. 1, Winter (December) 1957.

[7] The Emeloid Co., Inc., 189 F.2d 230 (3rd Cir. 1951), *rev'g* 14 TC 1295. See Lawthers, *op. cit. supra* Note 6.

[8] Casale, 247 F.2d 440 (2nd Cir. 1957), *rev'g* Oreste Casale, 26 TC 1020. See: *Casale reversal clarifies relation between stockholder and controlled corporation*, 7 JTAX 271 (November, 1957); Jones and Gleason, *Casale reversed*, 7 JTAX 258 (November, 1957); Lawthers, *Life Insurance Carried by a Corporation*, The Practical Lawyer, Vol. 3, No. 7 (November, 1957); and Lawthers, *op. cit. supra* Note 6.

[9] See Moline Properties, Inc., 319 U.S. 436 (1943), *aff'g Moline Properties, Inc.*, 131 F.2d 388 (5th Cir. 1942), *rev'g* 45 BTA 647.

[10] See Lawthers, *op. cit. supra* Note 6. Of course, for the First Circuit, we do have the dictum quoted above under "More from the opinion," as well as, for the Third Circuit, Emeloid (see Note 7) and, for the Eighth Circuit, Tucker, 226 F.2d 177 (8th Cir. 1955), *rev'g* Earle F. Tucker, 23 TC 115. We may hope for something of interest in the pending appeal to the Tenth Circuit of Sanders, 149 F. Supp. 942 (DC Utah, 4/27/57)—see Mannheimer and Friedman, *op. cit. supra* Note 3. If, as may be reasonably expected, Holsey (see Note 6) is appealed, the Third Circuit will have an opportunity to reaffirm its Emeloid position. A very interesting case, Pelton Steel Casting Co., 28 TC No. 20 (4/25/57), involving the Section 102 (1939 Code) penalty tax, is on appeal to the Seventh Circuit.

treasury stock. We have hitherto pointed out the limited utility of the concept of corporate purpose as distinguished from stockholder purpose. See *Lewis,* 176 F.2d 646, 649-50 (1949). But if it were necessary to look for a corporate business purpose in the present case, we could refer to the arguments in Mannheimer & Friedman, 'Stock-Retirement Agreements,' 28 *Taxes* 423, 425 (1950), as follows:

" 'Even while the decedent is still alive, the agreement and insurance benefit the corporation because they tend to stabilize the corporation's business. If the bank knows about the agreement, it may well be inclined to extend credit more liberally to the corporation because the possibility of inexperienced shareholders injecting themselves into the management is eliminated. If the key employees are informed of the agreement, it will be an inducement to them to remain with the corporation because they realize that the continuation of the business in the hands of the survivor is assured—and with it their jobs.

" 'If there is no stock-retirement agreement when the decedent dies, often his family will ask a high price for his stock, or demand dividends without regard to the needs of the corporation, or even press for dissolution. So far as the survivor is concerned, he may very well be unwilling to work indirectly for the benefit of his former "partner's" family or directly with the second husband of his former "partner's" widow.' "

Evaluation

It would be foolhardy to see this decision as indicating that there is no need for caution and for technical skill and care in setting up stock redemption arrangements and in establishing the details of life insurance policies carried by a corporation.

Other shareholders may not live in Massachusetts. Besides, each set of facts is going to be just a bit different, and the next group of taxpayers who act as ineptly as the Prunier brothers, or even much less so, may not be as happy in the Government's prosecution and their defense as were the Pruniers.

This decision is no more a license for bad or unothodox handling of potential stock redemptions than the *Casale* reversal was for deferred compensation agreements for controlling shareholders. All we have as law in either decision is: if no insulation of a life insurance policy from general corporate use—particularly no insulation against use, either during the life of the insured or after his death, to satisfy the claims of corporate creditors, if needed—then no income tax liability of any individual at the time of premium payment by the corporation.

As Judge Magruder said, "What will happen when one of the . . . [shareholders] . . . dies is not before us."[10] ☆

The impact of the Coastal Oil decision upon loss corporations

by **ALBERT E. ARENT**

Tax men have been much concerned about the implications of the Coastal Oil decision, wondering how far its rationale, and that of Libson Shops, would be extended. Mr. Arent evaluates the significance of these two cases in the field of loss carryovers. Practitioners dealing with the problems arising from changes in structure or ownership of loss corporations will find this article a guide through a very confused area.

SINCE 1944 a lawyer advising clients about loss carryover transactions has had to chart a course through dangerous waters. The Revenue Act of 1943 had introduced into the Code a loophole-plugging statute, written in the most sweeping terms, which could be read so broadly as to jeopardize many normal and unobjectionable business practices. With the passage of time, however, this statute, formerly Section 129 of the 1939 Code and now Section 269 of the 1954 Code, appeared to have lost its bite. For more than a decade every attempt by the Commissioner to breathe life into the section was set back by the courts.

Finally, in October 1955, the Tax Court did find an occasion to apply Section 129, but the case, involving consolidated returns, could hardly be considered cause for alarm.[1] A subsequent Tax Court decision continued to reassure taxpayers that the section would be read narrowly and applied with great restraint. The adoption in the 1954 Code of Sections 381 and 382, providing specific rules for dealing with loss carryovers, was based upon a recognition by Congress that Section 129, having attempted too much, had proved ineffectual as a deterrent to tax avoidance in the area of loss corporations.[2] Little wonder, therefore, that the dangerous waters of Section 269 began to look like Lake Placid and lawyers concentrated on meeting the specific rules of Sections 381 and 382 without too much concern for the threat of Section 269.

All this changed abruptly last April when the Court of Appeals for the Fourth Circuit, in *Coastal Oil Storage Company,*[3] reversed the Tax Court's determination that Section 129 was not applicable in the circumstances of that case. Even more surprising to most lawyers than the fact of reversal was the sweeping character of the court's construction of the statutory language. Suddenly Section 269 was back in business, looming not only as a serious threat to the kind of trafficking in loss corporations which had become a matter of notoriety, but also as a cloud over a wide variety of normal business transactions.

Section 269 disallows any deduction, credit or other allowance when (1) any person acquires control of a corporation, or (2) any corporation acquires property with a transferred basis from another corporation, and the principal purpose of the acquisition is to secure the benefit of such deduction, credit or other allowance. The impotence of the statute stemmed from two attitudes reflected in the decisions of the Tax Court: The first was the court's readiness to accept almost any plausible explanation of business purpose as proof that tax avoidance was not the principal purpose.[4] The second was an unwillingness to apply the statute to a corporation which was itself entitled to the deduction and which, therefore, did not obtain such deduction as a result of the acquisition of stock control or property with a transferred basis.[5]

The first attitude was very reassuring

but, being dependent upon a factual determination, left a degree of uncertainty for the lawyer trying to advise his client with respect to transactions involving loss corporations. The real comfort came from the second attitude. Wherever possible, transactions were shaped so as to have the corporation with the deductions, credits or other allowances, that is, the loss corporation, acquire the profitable corporation. Under the Tax Court rule, this eliminated the risk of Section 269, leaving only the special rules relating to loss carryovers to be dealt with. The provisions of Sections 381 and 382 of the 1954 Code, however complicated they may appear to be, are much easier to work with than the sweeping language of Section 269.

The Coastal Oil holding

In *Coastal Oil* the Fourth Circuit refused to accept the long-standing Tax Court construction of Section 269. Although the case involved the $25,000 minimum credit for surtax and excess profits tax purposes rather than loss carryovers, it is of the greatest significance in the area of loss corporations. Coastal Terminals, Inc., the parent corporation, was engaged in the operation of a petroleum products terminal. It formed the taxpayer, Coastal Oil Storage Company, and acquired 100% of its stock by transferring to it storage tanks previously used in its own business. The Tax Court held that Section 129 did not apply, because the taxpayer did not acquire the tax credits in question through the acquisition of control by the parent corporation or through the receipt of property with a transferred basis from the parent corporation; it already had such credits.[6]

The Government pointed out in its brief on appeal that the principal purpose which the section describes is not tax avoidance by securing a deduction, credit or other allowance, but tax avoidance "by securing the *benefit* of a deduction, credit or other allowance which such person would not otherwise *enjoy*." By emphasizing these words "benefit" and "enjoy," the Court of Appeals reached the conclusion that Section 269 could apply to disallow the credits to the acquired corporation. First, it was sufficient to invoke Section 269(a)(1) that the benefit accrued either to the parent corporation which had acquired control for the purpose of securing such benefit, or to the subsidiary which otherwise would not have enjoyed such benefit. Second, it was sufficient to invoke Section 269(a)(2) that the property transferred produced the income without which the credits in question would have been useless to the taxpayer. In other words, it makes no difference whether the taxpayer is the acquired or the acquiring corporation; the transfer of profitable activities is sufficient to invoke Section 269 where either the taxpayer or its stockholders secures a tax advantage from having these profits in corporate solution.

Distinction from Commodore's Point

The *Coastal Oil* decision may not mean all it appears to say. Neither the briefs nor the opinion cite any of the pertinent Tax Court decisions with the exception of *Commodore's Point Terminal Corporation*.[7] There an individual owned controlling stock in the Piggly Wiggly Corporation. This corporation was about to declare a dividend which would have been ordinary taxable income to the individual. He thereupon transferred his stock to another corporation controlled by him, the Commodore's Point Terminal Corporation. Through such transfer, the latter acquired control of the Piggly Wiggly Corporation and, upon receiving the dividend from Piggly Wiggly, claimed the usual 85% dividends received credit. The Commissioner sought to disallow this credit under Section 129. The Tax Court refused to apply the section, pointing out that Commodore's Point would be entitled to the dividends received credit whether it owned one share or controlling stock in Piggly Wiggly, and therefore the credit did not stem from the acquisition of control. The *Coastal Oil* decision attempts to distinguish *Commodore's Point* on the ground that the transaction was not one which involved tax avoidance. I find it difficult to comprehend why the acquisition of profitable assets in order to obtain the future income from such assets constituted tax avoidance in the *Coastal Oil* case but not in the *Commodore's Point* case. Perhaps the court is undertaking to distinguish between what is and what is not proper tax reduction.[8]

No one can predict how far the Fourth Circuit will carry its broad reading of Section 269, or whether its construction of the statute or that of the Tax Court will ultimately prevail. The immediate effect, however, is to immobilize many transactions involving legitimate business purposes but accompanied by the usual and inevitable tax considerations, since the parties can proceed only at their own peril. The Service will not grant rulings under Section 269 and no one can be absolutely sure that, in considering the evidence on the question of principal purpose, a court will not find the testimony of business purpose less persuasive than it seems to the parties planning the transaction.

Tax Court position

For those who are prepared to take a calculated risk there is comfort and reassurance in the Tax Court's long history of accepting at face value the testimony of respectable businessmen concerning their business purposes and their asser-

[1] American Pipe and Steel Corporation, 25 TC 351 (1955), *aff'd* 243 F.2d 125 (9th Cir. 1957).
[2] 83d Cong., S. Rept. 1622, p. 53.
[3] 242F.2d 396 (4th Cir. 1957), *rev'g* (on Sec. 129) 25 TC 1304 (1956).
[4] Alcorn Wholesale Company, 16 TC 75 (1951); Berlands, Inc. of South Bend, 16 TC 182 (1951); WAGE, Inc., 19 TC 249 (1952). Not until the fall of 1955 did the court find a case involving Sec. 269 in which tax avoidance was recognized as the principal purpose. See American Pipe and Steel Corporation, *supra* note 1.
[5] Alprosa Watch Corporation, 11 TC 240 (1948); Commodore's Point Terminal Corporation, 11 TC 411 (1948), *acq.* 1949-1 CB 1.
[6] Coastal Oil Storage Company, 25 TC 1304 (1956).
[7] 11 TC 411 (1948), *acq.* 1949-1 CB 1.
[8] The Commissioner has already opened the door to this type of approach in IT 3757, 1945 CB 200. In that ruling, the Commissioner held that the formation of a Western Hemisphere Trade Corporation for the principal purpose of obtaining the benefits of the surtax exemption then allowed to Western Hemisphere Trade Corporations was not such tax reduction as to constitute a tax avoidance purpose which would invoke Section 269. It is difficult as a purely technical matter to see any difference between a purpose to obtain a complete exemption from surtax under the Western Hemisphere Trade Corporation provisions and the purpose to obtain a limited $25,000 exemption from surtax under the tax rate section.
[9] 25 TC 351 (1955), aff'd 243 F.2d 125 (9th Cir. 1957). In this case, the taxpayer, a steel pipe corporation, acquired sufficient controlling stock in an active California real estate corporation to entitle it to file consolidated returns with that corporation. Absent this control, it could not have elected to file a consolidated return. The California corporation had owned a considerable amount of real estate having a very high basis. A number of years previously this had been sold for taxes, but the corporation was able to secure the right to reacquire the property for a limited period of time. Shortly after the acquisition of control by the pipe and steel corporation, the real estate corporation made several sales of such property which, at best, hardly looked like normal business arm's length sales, the purchasers being parties closely related to the pipe and steel corporation. The real estate company took very heavy losses on these sales, and the pipe and steel corporation attempted on a consolidated return to apply these losses of its subsidiary against its own profits. The Tax Court found that the sole purpose of the acquisition of the stock was to obtain the benefit of these losses as an offset against the parent company's income, and therefore denied the application of these current losses against the current income of the parent.
[10] 353 U.S. ——, 1 L. Ed. 2d 924 (1957).
[11] *Id.* at p. 929 (footnote 9 of the opinion).
[12] 83d Cong., H. Rept. 2543, pp. 39-40.
[13] The same treatment is accorded a tax-free liquidation of a subsidiary into a parent under Sec. 332, except where Sec. 334(b)(2), the statutory enactment of the Kimbell-Diamond rule, applies.
[14] Arent, *Tax Aspects of Buying Loss Corporations under the 1954 Code*, 33 TAXES 955 (December 1955); Arent, *Problems in Acquiring Closely-Held Loss Corporations*, N. Y. U. 15th ANN. INST. ON FED. TAX., 453; Arent, *Current Developments Affecting Loss Corporations*, 35 TAXES 956 (December 1957).

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tion under oath that tax benefit was not their principal purpose. There is nothing in *American Pipe and Steel Corporation*,[9] which involved a rather extreme set of facts, to make us believe that the Tax Court has departed from its traditional attitude. If a taxpayer has confidence in his ability to overcome Section 269 through proof of predominant business purposes, there is not too much difficulty, notwithstanding the absence after so many years of regulations interpreting Section 269, in charting a course under Sections 381 and 382 of the 1954 Code.

There has never been a problem where persons acquire ownership of a loss corporation and, by pouring resources and skill into its operation, succeed, without a change in its type of business or location, in making it a profitable venture, free of income tax burdens until the loss carryover is exhausted. Furthermore, a change of ownership of a loss corporation without a change in business, even though new skills and resources are diverted to the business, still appears to create no jeopardy for loss carryovers. Finally, where there is no change of ownership and no dominant tax avoidance motive, it appears safe for a loss corporation to acquire new profitable lines of business, provided it does not discontinue its previous business.

Libson Shops not a threat

At this point, however, mention must be made of the recent decision of the Supreme Court in *Libson Shops, Inc.*[10] The question before the Court was whether the surviving corporation in a merger of 17 commonly owned corporations—16 retail stores and a management company—was "the taxpayer" entitled under Section 122 of the 1939 Code to utilize the loss carryovers from premerger years of three of the merged corporations. None of the three stores involved had produced any profits after the merger. A unanimous court held that the tax entity for loss carryover purposes is not strictly the legal entity, but rather the business enterprise which had previously established itself as a tax-reporting unit. Carryovers produced by one business enterprise cannot be applied against profits produced by another business enterprise. This principle admittedly casts a shadow of doubt upon my conclusion that loss carryovers may be used under the 1954 Code to offset the profits of a newly acquired business. However, my disposition not to take *Libson Shops* too seriously as a deterrent in current planning with respect to loss corporations stems from the following considerations:

1. The court was dealing with statutory language that is no longer in the Code.

2. The court was careful to point out that it was not passing upon the question of a single continuing corporate entity as contrasted with a combination of entities.[11]

3. An attempt to impose the business entity principle of *Libson Shops* upon the specific loss carryover provisions of the 1954 Code would override the declared intention of Congress as explicitly set forth in Sections 381 and 382 of the 1954 Code.

Another risk which must be mentioned is the possibility that the Regulations, drawing hopefully upon *Libson Shops* concepts, may declare that there is no continuation of the same business within the requirement of Section 382 where the new lines of business which are introduced overshadow the old business. Such regulations would have to ignore the plain statement in the Committee Report on Section 382 that the addition of new businesses is not to be deemed a discontinuance of the old business.[12]

What is change of ownership?

The rules adopted by Congress in Section 382 of the 1954 Code were designed to deprive corporations of their loss carryovers only where there was both a 50% change of ownership and a change in the nature of the business. The change of ownership is significant, however, only if it is accomplished by a purchase of stock. Purchase is defined as an acquisition of stock, the basis of which is determined solely by reference to the holder's cost. It is frequently easy to avoid a purchase while achieving a substantial change of ownership by utilizing one of the many forms of tax-free exchanges or reorganizations which exist under the tax laws. The corporation is permitted to retain and utilize its tax losses, notwithstanding a substantial change of ownership and a change in the kind of business, where the change in ownership is effected through a Section 351 transfer, that is, where the new owner has acquired 80% control after a transfer directly to the loss corporation in exchange for stock; or through a reorganization under Clause (B) of Section 368(a)(1), that is, where the stockholders of the loss corporation exchange its stock for voting stock of another corporation which after the exchange has 80% control of the loss corporation; or through a recapitalization that comes within Clause (E) of the reorganization section, as where the loss corporation issues stock to bondholders in exchange for their bonds.

Section 382(b) provides a different rule where the change of ownership is effected through a Clause (A), (C), (D) or (F) reorganization. These reorganizations are statutory mergers and consolidations, the transfer of substantially all of the assets of one corporation for voting stock of another, the transfer of all or part of the assets of one corporation for controlling stock in another (provided, however, that such stock is distributed to the shareholders of the transferor), or a mere change in identity, form or place of organization. In such cases the loss carryovers are, pursuant to Section 381, transferred to a different corporation.[13]

In these situations the full benefit of the loss carryovers can be retained only if the stockholders of the loss corporation, as a result of such stock ownership, own immediately after the reorganization at least 20% of the fair market value of the outstanding stock of the acquiring corporation. If they do not, the loss carryover is proportionately disallowed. For example, if they acquire only 19% ownership, then 5% of the loss carryover is disallowed. If they acquire 18% ownership, then 10% of the loss carryover is disallowed.

In previously published papers I have set out at greater length the reasons which lie behind the conclusions presented here.[14] In them I have tried to demonstrate that any attempt to use the *Libson Shops* opinion and Section 269 in the area for which Congress laid down the specific rules of Sections 381 and 382 would create the kind of confusion and uncertainty that Congress was trying to avoid. I question whether the advantage which the Government may derive in frustrating occasional tax avoidance schemes justifies the amount of interference and upset which the new doctrine would create for normal and legitimate business transactions. ☆

New corporate decisions this month

Corporate entity can't be disregarded by stockholder. Taxpayer claimed that a corporation which he organized to conduct timber milling operations was never really a corporate entity for tax purposes since it failed to comply with all state requirements. Accordingly, taxpayer argued that his "advances" to the "corporation" were in reality to his own business venture so that subsequent losses were recognizable to him individually. The court disagrees, maintaining that if a corporation engages in business activity subsequent to its incorporation, its entity will not be disregarded for tax purposes. *O'Neill,* TCM 1957-183.

Incorporation of partnership tax-free; but 11-to-1 ratio of debt to capital too "thin" [*Certiorari denied*]. In a series of transactions, the individual partners of a limited partnership transferred their interests to a newly-formed corporation. Thereafter, each had the same interest in the corporation as he had had in the partnership. In form they received corporate notes totaling some $530,000 and subscribed for all the $50,000 stock. The Tenth Circuit held the exchange was tax-free under Section 112(b)(5) of the 1939 Code; the corporation retained the partnership's basis for the assets. However, the "indebtedness" was held to be really a proprietary interest in the nature of stock, as the ratio of debt to capital was 11 to 1 and the notes were held in the same proportion as the stock. "Interest" payments on the notes, being in substance dividend payments, are therefore nondeductible. *Gunn, cert. den.* 10/14/57.

Distribution after consolidation was dividend. Taxpayer was a stockholder in a corporation which entered into a consolidation with two other corporations. Taxpayer received stock of the consolidated company in a tax-free exchange for his stock. The agreement of consolidation provided that taxpayer's corporation was to contribute $2,400,000 of assets and that if it should be determined that the actual assets were more or less than this amount, the shareholders of that corporation would receive or contribute the difference, as the case may be. Nearly three years later it was determined that the corporation had contributed $120,000 excess assets, and cash of this amount was distributed to its former stockholders. This distribution is a dividend to taxpayer; it was a distribution from earnings. It is immaterial that it was not formally declared as such. *Davis,* DC Tenn., 9/19/57.

No dividend on redemption of preferred exchanged for salary notes [*Acquiescence*]. From 1942 to 1945, taxpayer received notes from his corporate employer in settlement of his salary and reported their full face value as taxable income. Later, several of the notes were exchanged for preferred stock to improve the corporation's credit position. The Tax Court held that redemption of the preferred was not a taxable dividend; it was merely the completion of the initial transaction of repaying the notes and making a cash salary payment for which the notes had originally been issued. *Golwynne Estate,* 26 TC No. 1209, *acq.* IRB 1957-38.

Interest on deficiencies reduces corporate earnings. Taxpayer in 1948 and 1949 withdrew funds from his corporation which, it was conceded, were dividends if the corporation has accumulated earnings. He claimed it did not because of fraud penalties and interest for those years and prior ones. The court reaffirms the position it took in *Stein* (25 TC 940, *acq.* IRB 1957-29; now on appeal) that fraud penalties accrue when the return is filed. It concludes that interest likewise begins to accrue then even though the deficiencies are litigated and not agreed to until later. The court notes that this is apparently the first time this question has been litigated. It agrees that for the purpose of claiming a deduction for interest expense it would not accrue until the contest ended. For the purpose here it must, as it said in *Stein,* determine the true financial position on an accrual basis and to do this must show the tax liability whether taxpayer was aware of or agreed to the liability. *Stark,* 29 TC No. 17.

No dividend in preferred-stock redemption pursuant to plan [*Acquiescence*]. A redemption by a corporation of part of the preferred stock of taxpayer, an officer, and all of the preferred of his wife, is held not to be essentially equivalent to the distribution of a taxable dividend. The repurchase by the corporation was made pursuant to the terms of the original stock issue which directed its retirement at a fixed price only slightly above par upon contraction of business operations, which event actually occurred. *Bullock,* 26 TC 276, *acq.* IRB 1957-41.

Farm corporation has no income on its dividends paid in kind. A corporation distributed agricultural products as a dividend in kind; the IRS holds that the excess of the fair market value over the cost is not includible in the corporation's gross income. However, the costs are not deductible and must be removed from opening inventory and subsequent cost records. *Rev. Rul.* 57-490.

Pro-rata redemption of preferred equivalent to a dividend (Old Law). Payments received in 1950 and 1951 by the stockholders of a successful and expanding manufacturing company in pro-rata redemption of their preferred stock are held to be essentially equivalent to the distribution of a taxable dividend. There was no change in the stockholders' proportional interest in the common shares, no corporate business purpose, and no contraction of corporate invested capital. The Tax Court held the net effect of the redemption is the same as if a cash dividend had been paid. This court affirms. *Kessner,* CA-3, 10/29/57.

Cancellation of stockholders' notes a dividend. A syndicate purchased all of the outstanding stock of a corporation from its former stockholders by, in effect, borrowing the money from the corporation on promissory notes. The stock certificates were held by the corporation as security for the payment of the notes. The notes were canceled by the corporation two years later in exchange for 75% of the stock. The Tax Court held the syndicate members realized a taxable dividend to the extent of the accumulated corporate surplus. This court affirms. *Bell,* CA-6, 10/25/57.

Commissioner argues redemption not a dividend!! Reason: taxpayer is a corporation. Taxpayer-corporation owned 40.4% of the total stock of Western Oil. Western purchased some shares from taxpayer, leaving the taxpayer holding 20.1% of the outstanding stock. Taxpayer treated the "redemption" as

essentially equivalent to a taxable dividend and took a dividend credit of 85%. This court, reversing the Tax Court, agrees. These transactions did not amount to a partial liquidation. *Pacific Veg. Oil Corp.*, CA-9, 7/8/57.

Insurance used to buy decedent's stock for survivors not a corporate asset and not a dividend to them. A stockholders' agreement provided that certain of the corporate officers were to obtain life insurance with themselves as trustees named the beneficiaries. The corporation was to pay the premiums. Upon the death of any insured, the proceeds were to be collected by the trustees and distributed to the surviving stockholders in proportion to their stock ownership. When the president died, the remaining trustees used the insurance proceeds to purchase the decedent's stock on behalf of the surviving stockholders. The Tax Court held the trustees were agents of the corporation, and the corporation in effect received the proceeds of the policy which, though not representing income in its hands, did represent income to its stockholders when distributed to them through the purchase of stock for their benefit. This court reverses. The Tax Court erred in regarding the corporation as the beneficiary of the policy. It was not, though it treated itself on the tax return as if it was. Despite the confusion, this court is satisfied the trustees acted for the individuals. *Doran*, CA-9, 7/9/57.

Reorganization taxable; one stockholder bought out another before completion [*Acquiescence*]. In 1947 Brown corporation, which was engaged in the production of agricultural sprayers and velocipedes, transferred its velocipede business to an existing corporation, Velo-King, in exchange for debenture bonds which were distributed to stockholders of Brown in cancellation of a portion of their stock. Prior to this reorganization taxpayer and another man were in control of both corporations; just before completion of the reorganization taxpayer bought out the other's interest in the Brown corporation. Since there was either a lack of continuity of interest of Brown stockholders in Velo-King, or an intra-stockholder purchase not provided for in the plan of reorganization, gain or loss on taxpayer's exchange of his Brown stock for Velo-King debentures is recognized. But the court holds the exchange was not taxable as a dividend; it constituted a partial liquidation subject to capital gains rates. *Bullock*, 26 TC 276, *acq.* IRB 1957-41.

Dividend in spinoff of manufacturing assets leaving only rental properties in old corporation. A corporation manufacturing heating equipment owned its own plant and also an old factory building in a different location used for storage purposes, and several small dwellings that produced only a nominal rental. It desired to spin off the assets applicable to the manufacturing business, including the operating plant, to a new corporation and then distribute the new stock to the shareholders. The Service holds the activities in connection with the old factory building, and the rental of the dwellings, did not constitute the active conduct of a separate business. Since Section 355(a) of the 1954 Code permits a tax-free separation of two or more businesses only if such businesses are actively conducted throughout the five-year period preceding distribution, in the instant case the distribution of the new corporate stock to the shareholders is held to result in a taxable dividend. *Rev. Rul.* 57-464.

"Downstairs" merger of foreign holding company is a reorganization. A domestic parent owned all the stock of a foreign holding company which in turn owned all the stock of a foreign operating company. A "downstairs" merger of the holding company into its wholly owned operating subsidiary is held to constitute a tax-free reorganization, so that no gain or loss would be recognized to the domestic parent upon the exchange of stocks pursuant to the reorganization. This is a "D" reorganization; it is not a "statutory merger" (A type); that definition includes only mergers of domestic corporations. It meets the D test because the operating company acquired substantially all the assets of its parent, including the shares in the operating company itself. *Rev. Rul.* 57-465.

70% of assets "substantially all of properties" for reorganization. A corporation is considered as having transferred "substantially all of its properties" so as to qualify the transaction as a Section 368(a)(1)(C) reorganization even though it has retained 30% of the assets. These retained assets were approximately equal to its liabilities, and were cash, accounts receivable, notes, and 3% of its total inventory. *Rev. Rul.* 57-518.

Unused credit of acquired corporation not available as carry-back. Dumont-Electric dissolved in 1953 immediately after transferring its assets to taxpayer in a tax-free reorganization. The court holds taxpayer is not permitted to carry back and deduct from its own excess profits tax liability for 1952 the unused excess profits credit of Dumont-Electric for 1953 because taxpayer was not the "taxpayer" which sustained the unused credit. *Dumont-Airplane*, 28 TC No. 157.

"Sale" was exchange of like properties and nontaxable. Farm land belonging to an incompetent was "exchanged" for another tract of farm land by means of a technical sale and purchase because state law did not permit the guardian to exchange his ward's property for like property. The Service holds the sale will be disregarded and the transactions will be treated as an exchange of like properties for purposes of nonrecognition of gain. *Rev. Rul.* 57-469.

Refusal to recognize loss-sharing agreement remanded to Tax Court. Taxpayer organized and directly supervised a woolen mill. All of the common stock was given to his daughter while he retained the nonvoting preferred. He advanced large sums to the corporation under an agreement that the advances were to be repaid from profits, and that he was to assume all losses of the business. The corporation sustained losses for the years in question. The Tax Court denied taxpayer deductions for the losses, holding the arrangement was not bona fide. This court says it does not think that conclusion justifiable. It remands the case to the Tax Court for a determination whether the change in legal relations effected by the agreement was a sufficient basis to shift the losses. In a separate opinion, Judge Learned Hand suggests the test: did taxpayer suppose the agreement affected his beneficial interest in the venture, other than taxwise? *Haas*, CA-2, 10/7/57.

Predecessor's error in determining basis does not bind taxpayer receiving asset in reorganization [*Acquiescence*]. Taxpayer's predecessor did not report on its tax returns any gain derived in 1925 from its exchange of stock for certain properties, although the exchange was in fact a taxable transaction. Taxpayer-corporation later acquired the properties in a nontaxable reorganization and sold them in 1945. The court holds taxpayer's

basis for the properties was equal to the value of the stock exchanged for them back in 1925. The fact that taxpayer's predecessor treated that exchange as though no gain or loss resulted did not prevent taxpayer, either by equitable estoppel or by a duty of consistency, from correctly computing the basis on subsequent sale. *The Manahattan Building Co.* 27 TC 1032, *acq.* IRB 1957-41.

Payments to related corporation deductible as ordinary business expense. Payments by taxpayer to a related corporation for use of the latter's space, and for the services of the latter's employees, are held deductible as ordinary and necessary business expenses. In addition the Commissioner asserted that taxpayer had not shown that a payment of $4,250 to a related agency employed to investigate the possibility of adding a new line was an ordinary and necessary expense even though the survey project was discontinued when taxpayer decided to liquidate. As proof of the fact that the agency did perform valuable services, it was shown that the new line was adopted by taxpayer's successor. *Funkhouser Industries, Inc.,* TCM 1957-197.

Price paid for stock plus leasehold interest attributed primarily to stock [*Acquiescence*]. Two partners transferred all of the partnership assets, except for a leasehold it owned, to a corporation in return for all of the corporate stock. Later, one stockholder sold his stock interest plus his one-half interest in the leasehold to the corporation ostensibly for $10,000 and $40,000 respectively. The corporation sought to amortize the $40,000 payment over the 16-month remaining life of the lease. The Commissioner argued that the entire payment was allocable to the stock. The court, however, found that while the total consideration of $110,000 must be considered as having been paid primarily for the stock interest, $3,000, should be allocated to the leasehold interest. *Zenith Sportswear Co., Inc.,* 28 TC 455, *acq.* IRB 1957-41.

Court hints Section 337 may be inapplicable if assets go to creditors in liquidation [*Certiorari denied*]. Three public utility companies, insolvent since 1930, proposed a reorganization under Chapter X of the Bankruptcy Act. The plan provided a selling price ($8 million), substantially in excess of the basis of the assets. Upon request by the trustees for the companies, the Commissioner ruled that the corporate gain would be recognized since all distributions would go to the creditors. Section 337 would exempt gain on assets sold in the course of a 12-month liquidation. However, the Commissioner interpreted the Section 337 phrase that "all assets . . . are distributed in complete liquidation" to mean distribution to *stockholders* in redemption of stock. The Sixth Circuit refused to determine whether the Commissioner is correct. This proceeding is litigation of a proposed plan and is in effect a request for a determination of a hypothetical question. However, the circuit court pointed out that Section 337 had its origin in the *Court Holding Co.* (324 U.S. 331) and the *Cumberland Public Service Co.* (338 U.S. 45) cases, wherein the question was whether property was sold by a corporation or its stockholders. The inference is that the Commissioner's ruling may be justified by the legislative history. *Inland Gas Corp., cert. den.* 10/14/57.

Oil exploration not a separate "active business" prior to receipt of income. A corporation engaged in the refining and marketing of petroleum products began in 1947 to study the possibility of obtaining oil on a specific tract. It obtained exploration rights in 1951 and found oil in commercial quantities in 1954. Actual expenses for the geological surveys and exploration and drilling activities were substantial. When oil was discovered, the exploration and producing assets were transferred to a new corporation in exchange for 80% of its capital stock, and the new stock was distributed to the old corporation's stockholders. The Service holds that the spinoff was not tax-free under Section 355; the exploration and drilling conducted by the old corporation did not meet the five-year "active business" test. The Regulations define an active business as including income production. Until 1954, there was no business in that sense. *Rev. Rul.* 57-492.

For purposes of determining gain or loss on sale of assets of dissolved corporation, local law ignored. Taxpayer, a trustee of a dissolved Hawaiian corporation, had, after the certificate of dissolution was issued, sold assets of the corporation at a gain, and argued that under Hawaiian law there was no longer any corporation and therefore he sold the property on behalf of the stockholders individually. The court, however, upholds the Treasury Regulation that sales of property by trustees in liquidation are to be treated as if made by the corporation for the purpose of ascertaining gain or loss. Irrespective of local law, this regulation continues the life of a corporation for tax purposes. *Loo,* CA-9, 10/10/57.

Determination of gain or loss on sale of affiliate's stock. In determining gain or loss on sale by a member of an affiliated group of stock of another member of the group, the basis of the stock is required to be reduced by all operating losses sustained by the issuing corporation for the taxable years it was a member of the affiliated group, but only to the extent that such loss could not have been availed of by it if separate income tax returns had been filed for each of such taxable years. The basis must be further reduced by the issuing corporation's proportionate share of consolidated losses not availed of for such taxable years. *Rev. Rul.* 57-455.

Redemption of wife's stock not a dividend though husband is stockholder (Old Law). Husband (the Postmaster-General of the United States) and wife owned their shares in an auto agency as joint tenants from 1933 until 1948. In 1948, they severed the joint tenancy, the stock of the wife being redeemed at book value. This court affirms the district court's holding that the redemption was not substantially equivalent to a dividend distribution because the wife sold all her stock. The Regulations at that time held that a redemption of all the shares of a stockholder was nontaxable. The sale is therefore taxable as capital gain. [The 1954 Code provides specific rules on when a redemption is treated as a sale.—*Ed.*] *Summerfield,* CA-6, 10/26/57.

Transferor's holding period tacked on to determine collapsibility. The three-year holding period relating to collapsible corporations begins the day following completion of "manufacture, construction, production, or purchase of the property." If a corporation receives real estate in a tax-free incorporation, its holding period includes the period during which the property was held by the transferor. If more than three years have elapsed since that date, the corporation can be liquidated without being classified as collapsible. *Rev. Rul.* 57-491.

INCOME TAXATION OF
Trust & estates

Preparing Form 1041: how income, deductions, distributions are reported

by **WILLIAM K. STEVENS**

The red paper used for the Fiduciary Income Tax Return Form 1041 might well be interpreted as a warning to the practitioner preparing the return that new concepts and new principles have been adopted for the taxation of the income of trusts. The completely revised Form 1041 is designed in a manner that reflects these new concepts and principles. Mr. Stevens reviews for us here the particular import of terms such as "substantial owner," "simple and complex," "income required to be distributed currently," "other amounts paid, credited, or otherwise required to be distributed," "distributable net income," "distributions deduction" and "accumulation distribution" found both in Form 1041 and the express language of Subchapter J of the 1954 Code, and shows specifically how they are reported on 1041.[1]

A DISTINCTION should first be made between trusts which are taxable entities and trusts which are not. A fully revocable trust is a separate entity having independent legal significance for purposes of trust law, but for Federal income tax purposes it is not a separate taxable entity. For tax purposes the grantor is simply treated as the owner of the trust and the income, deductions and credits against tax of the trust are reported on his own individual return in the same manner and to the same extent that they would be reportable if no trust existed.

The basis for this approach is set forth in Sections 671 and 676, but perhaps it is best illustrated by a recent Revenue Ruling.[2] A trustee inquired whether he could file returns on a fiscal year basis without the consent of the Commissioner where the trust had become irrevocable upon the death of the grantor. While the grantor was living, the trust was fully revocable. The grantor had reported the income in his return and paid the tax each year, and the trustee had filed fiduciary income tax returns as information returns on a calendar year basis. The Commissioner held that upon the death of the grantor "the trust became a separate entity for Federal income tax purposes for the first time and hence a new taxpayer." The trustee could elect to file on a fiscal year basis without the consent of the Commissioner because for tax purposes the existence of the trust prior to the time it became irrevocable was ignored.

Substantial-owner trusts

Substantial-owner trusts are not separate taxable entities. The portion of trust income taxable to the grantor of a trust or to another person as substantial owner is *not* reported on the fiduciary income tax return form.[3] Such income and applicable deductions and credits are shown on a separate statement attached to the form. Income, applicable deductions and credits are set forth on the form itself only where and only to the extent that the trust is a separate taxable entity for Federal income tax purposes. Before filling out a fiduciary income tax return one must, therefore, determine whether or not the trust in question is a substantial-owner trust, in whole or part.

There are five reasons why the income of a trust may be attributable to the grantor and the grantor treated as the owner of the entire trust or a part of it: (1) a retained power to revoke,[4] (2) a retained right to income,[5] (3) a retained reversionary interest,[6] (4) a power to control beneficial enjoyment,[7] or (5) a retained administrative power.[8]

If a grantor reserves a power to revoke a trust, he is treated as the owner of the trust income. However, if he may revoke the trust only with the consent of an adverse party, he is not treated as the owner. A person who has a substantial interest in the trust property which would be adversely affected by the exercise of the power to revoke is an "adverse party." Thus, if A creates a trust with income payable to B for life and at B's death as B appoints by will and retains a power to revoke with B's consent, A would not be treated as the owner of the trust income and taxable. B is considered to be an adverse party, for he has a definite economic interest in the trust income and would not be likely to accede to the wishes of the grantor if he wished to revoke the trust. If, however, the grantor retains a power to revoke with the consent of C, a disinterested trustee, or D, a person who has no beneficial interest in the trust, the grantor would be treated as the owner and taxable with the income.

If the income of a trust is, or may be, without the consent of any adverse party, paid or accumulated for the benefit of the grantor, or used to pay premiums of insurance on his life,[9] he is treated as the owner.

A grantor is to be considered the owner of any portion of a trust if he has a reversionary interest in the corpus or in the income which may be expected to take effect within a period of ten years.[10] An exception to this rule is made for a trust where the income must be paid to

[1] 1954 Code Sec. 641-683.
[2] Rev. Rul. 57-51, IRB 1957-6, 14; See also Rev. Rul. 57-390, IRB 1957-35, 16.
[3] 1956 Instructions for Form 1041, p. 2, 0.
[4] 1954 Code Sec. 676; Reg. Sec. 676(a)-1.
[5] 1954 Code Sec. 677; Reg. Sec. 1.677(a)-1.
[6] 1954 Code Sec. 673; Reg. Sec. 1.673(a)-1.
[7] 1954 Code Sec. 674; Reg. Sec. 1.674(a)-1.
[8] 1954 Code Sec. 675; Reg. Sec. 1.675-1.
[9] Other than policies of insurance irrevocably payable for a charitable purpose.
[10] The grantor is not treated as the owner under Section 673 of his reversionary interest is not to take effect until the death of the income beneficiary even if the life expectancy of the income beneficiary is less than ten years. 1954 Code Sec. 673(c).
[11] 1954 Code Sec. 673(b); income must be paid to a church, or a convention or association of churches, an educational institution, a hospital or to a qualified medical research organization.

a designated charitable institution; in such case the grantor is not considered the owner if the term of the trust is for two years or more.[11]

He is also to be taxed where he retains a power to control the beneficiary enjoyment; for example, the retention of the power to change beneficiaries, or to direct a trustee how income is to be divided among the beneficiaries is sufficient to make the grantor the *owner* for income tax purposes.

The fifth reason for taxing the grantor, a retained administrative power, is to be found where he has authority to borrow or purchase trust property without full and adequate consideration, or where he has a nonfiduciary power to direct the voting of trust stock or to control trust investments where the stock ownership is important from the standpoint of voting control. This latter situation may easily arise where a trust consists primarily of stock of a family corporation, if the grantor retains a power to direct how stock of the company is to be voted in a nonfiduciary capacity.

A person other than a grantor may also be treated as the substantial owner of a trust where he has a power to vest the entire corpus or the income in himself.[12] If, for example, a husband establishes a trust for the benefit of his children and gives his wife the complete power to withdraw the entire trust corpus at any time, the wife is considered to be the substantial owner and the trust income is taxable to her, and the trust is disregarded for income tax purposes. She treats the trust income as though it were her income and takes into account in computing her income tax liability all items of income, deduction and credit (including capital gains and losses) to which she would be entitled had the trust not been in existence.

Where a decedent's will creates two testamentary trusts, a marital trust giving the widow income for life and a right to withdraw any part or all of the trust corpus, and a residuary trust also giving the widow income for life but no power of withdrawal, two Form 1041's are filed. The return for the *marital trust* in this case is simply an information return. The trust income, deductions and credits are not listed on the return itself but on a separate statement attached. The widow treats the various items in her own personal return in the same way and to the same extent that she would if no trust existed. The return for the *residuary trust* is a return for a separate taxable entity, either a simple or a complex trust, depending upon the terms of the will. The income, credits and deductions, including the deduction for distributions to beneficiaries, would be reported on the return itself. If capital gains are allocated to principal and not distributed, the tax on such gains would be attributable to the trust.

Simple and complex trusts

Trusts which are treated as separate taxable entities are divided into two basic categories, *simple* and *complex*. A trust is a simple trust during its taxable year if (a) its terms require that all of its income be distributed currently, (b) no amounts other than income required to be distributed currently, are distributed to a beneficiary, that is, no principal payments are made during the year, and (c) no amounts are paid or accumulated for charitable purposes.[13] All trusts failing to meet these three requirements are complex trusts, and all estates are treated in the same manner as complex trusts.[14]

The same trust may be a simple trust in one year and a complex in another year. If, for example, all of the income of the residuary trust under a will is distributable to the income beneficiary each year, and the trustee has a broad discretionary power to pay principal to the income beneficiary; in years when only income is paid to the income beneficiary the trust is considered to be a simple trust, but in years when principal as well as income is paid to him the trust becomes a complex trust. In the year of termination when the trust principal is distributed to the remaindermen, the trust is treated as a complex trust.[15]

Any trust which is required to distribute all of its income currently is allowed an exemption of $300.[16] Not only are all simple trusts allowed the $300 exemption, but in addition a trust required to distribute all income currently, with a portion going to charity may take the $300 exemption even though it is not a simple trust. Similarly, where the instrument requires that all of the income be distributed currently to a beneficiary, payments of principal during the year change the trust from a simple to a complex trust for such year, but the $300 exemption is still allowable. To determine whether the $300 exemption is allowable, it is only necessary to determine whether or not the trust is one which is required to distribute all of its income currently. If so, the exemption is $300, but if not, it is only $100. The exemption is only $100 for any trust which accumulates income, other than capital gains.

Short-form method for simple trusts

The trustee of a simple trust may use either a short or a long-form method for completing the Form 1041.[17] If the short-form method is used, Schedules E (dividend credit), F (charitable deduction), G (distributable net income), and H (distributions deduction) need not be completed. With a simple trust all of the ordinary income is currently distributable, and there is no occasion to compute the trustee's portion of the dividend exclusion, and the trustee's share of the dividend credit. Ordinarily, all of the dividend income of a simple trust passes through the trust as through a conduit to the income beneficiary to be reported by the beneficiary in his own return. There is an exception to this rule in the case of a simple trust receiving extraordinary dividends or taxable stock dividends which are allocated to principal and not paid to a beneficiary.[18] If the exception applies, Schedule E (dividend credit) should be filled in even though the trust is a simple trust.

If any amounts are paid or accumulated for charitable purposes during the year, the trust by definition is a complex trust rather than a simple trust. Schedule F (charitable deduction) is inapplicable to a simple trust.

Schedules G (distributable net income) and H (distributions deduction) are filled in if the long-form method is used for a simple trust, but need not be filled in if the short-form method is used. The concepts of *distributable net income* and *distributions deduction*, introduced by the 1954 Code are, however, very important in determining the income tax status of all trusts which are taxable entities, whether simple or complex, whether the short or the long-form method is used and whether or not Schedules G and H are completed.

[12] 1954 Code Sec. 678; Reg. 1.678(a)-1.
[13] 1954 Code Sec. 651; Reg. 1.651(a).
[14] 1954 Code Sec. 661.
[15] Reg. 1.651(a)-3.
[16] 1954 Code Sec. 642(b); Reg. 1.642(b)-1.
[17] 1956 Instructions for Form 1041, p. 3.
[18] 1956 Instructions for Form 1041, p. 2.
[19] 1954 Code Sec. 643(a); Reg. 1.643-1.
[20] The general rule is that all distributions to beneficiaries are income to the extent that there is distributable net income of the taxable year. An exception to this rule is made in Section 663(a)(1) for any amount which, under the terms of the governing instrument, is properly paid or credited as a gift or bequest of a specific sum of money or of specific property and which is paid or credited all at once or in not more than three installments. Section 663(a)(1) requires that for the exception to apply the gift or bequest must be payable from corpus or from income or corpus, but not solely from income.

Short Forms for Simple Trusts

Line		No Capital Gain or Loss			Capital Gain	
		Figure 1	***Figure 2***	***Figure 3***	***Figure 4***	
1.	Dividends (full amount before exclusion)	5,000	5,000	5,000	15,000	
2.	Interest on bank deposits, notes, corporate bonds, etc.	6,000	6,000	6,000	12,000	
4.	Interest on government obligations, etc.				7,000	
8b.	Net gain from sale of capital assets				2,000	
10.	Total income	11,000	11,000	11,000	36,000	
15.	Other deductions	1,000	687.50	1,000	4,000	
16.	Total Deductions	1,000	687.50	1,000	4,000	
17.	Line 10 minus line 16	10,000	10,312.50	10,000	32,000	
18.	Deductions for distributions to beneficiaries	10,000	10,312.50	10,000	30,000	
21.	Long-term capital gain deduction				1,000	
22.	Exemption				300	
23.	Total lines 18 to 22	10,000	10,312.50	10,000	31,300	
24.	Taxable income of fiduciary	0	0	0	700	
	Schedule A Explanation of Deductions					
	Trustees fees charged to trust income	1,000			3,000	
	Trustees fees charged to trust income $1,000 less portion allocable to tax exempt income		687.50			
	Trustees fees charged to trust corpus			1,000	1,000	
					$4,000	
	Schedule C—Beneficiaries Shares of Income and Credits					
Column						
1.	Name	John Doe	John Doe	John Doe	John Doe	Henry Roe
3.	Income required to be distributed currently	10,000	15,000	11,000	15,500	15,500
5.	Domestic dividends qualifying for credit	5,000	5,000	5,000	7,500	7,500
7.	Income taxable to beneficiaries (less portion reportable in 5)	5,000	5,312.50	5,000	7,500	7,500
10.	Tax exempt income	0	4,687.50	0	0	0

Distributable net income limits the amount of trust income taxable to the income beneficiary of the trust and is used to determine the character of distributions.[19]

Distributable net income means for any taxable year, the taxable income of the trust, computed with the following modifications:[20]

1. The deduction for distributions to beneficiaries is not allowed.

2. The deduction for personal exemption is not allowed.

3. Capital gains are excluded unless allocated to income, distributed, or paid, or set aside or used for charitable purposes.[21]

4. In the case of a simple trust, extraordinary dividends and taxable stock dividends allocated to corpus are excluded.

5. Tax-exempt interest, reduced by applicable expenses, is included.

6. Income of a foreign trust, reduced by applicable expenses, is included.

If the gross income of a simple trust is $11,000, $5,000 in dividends and $6,000 in taxable bond interest, and the only expense is a trustee's fee of $1,000, the distributable net income of the trust is $10,000. If, however, the gross income of the trust were $16,000, $5,000 in dividends, $6,000 in taxable bond interest and $5,000 of tax-exempt interest, and the only expense is a trustee's fee of $1,000, the distributable net income would be $15,000. Tax-exempt interest, reduced by applicable expenses, must be included.

Distributions deduction

A trust is allowed a deduction for distributions to beneficiaries. The *amount of income required to be distributed currently* and *other amounts paid, credited, or otherwise required to be distributed,* are deductible by the trust, subject to two limitations.[22] (1) The distributions deduction may not exceed the distributable net income of the trust; and (2) the deduction is limited by excluding items making up distributable net income which are not included in determining the gross taxable income of the trust, such as tax-exempt interest.

In the first example mentioned above, (See Figure 1) that is, a simple trust with income of $11,000 and an expense of $1,000, the *amount of income required to be distributed currently* would be $10,000 and the *distributions deduction* would also be $10,000. In the second example (See Figure 2), the *distributions deduction* would be $10,312.50. There the *distributions deduction* is computed by first making sure that the *amount of income required to be distributed currently,* $15,000, does not exceed *distributable net income,* $15,000, and then by excluding the tax-exempt interest included in distributable net income, $4,687.50. (Tax-exempt interest of $5,000 reduced by $312.50, the applicable portion of the fee, 5,000/16,000 of $1,000). The amount of the distributions deduction would be $15,000 minus $4,687.50, that is $10,312.50.

Short-form method for simple trust

Figure 1 illustrates the way in which the short-form method may be used,

based upon the first example mentioned above. The $5,000 in dividends is entered on Line 1 and the $6,000 taxable bond interest on Line 2, and these items are totalled on Line 10. The Schedule A deduction, in this case the trustee's fee of $1,000, is entered on Line 15 and on Line 16. The deduction figure on Line 16 is subtracted from the income items totalled on Line 10, and $10,000 is entered on Line 17.

The next step in the short-form method is to enter the appropriate amount in column 3 of Schedule C.[23] Column 3, "Amount of income required to be distributed currently," is designed to show the amount of trust income to which the beneficiary, John Doe, is entitled as determined for fiduciary accounting purposes, and not as determined for income tax purposes. The amount to which he is entitled is determined by the terms of the governing trust instrument and, if the instrument is silent, under the applicable principal and income statute. If it is assumed that the instrument is silent in this case and the Uniform Principal and Income Act applies, the $1,000 trustee's regular annual fee is chargeable to trust income and the amount required to be distributed currently is $10,000.[24] This amount, the maximum which may be taxable to John Doe, is entered in column 3 of Schedule C. Column 3 of Schedule C sets one limitation on the amount which may be taxable to the beneficiary of a simple trust, for he cannot be taxed with more than he is entitled to receive.

For a simple trust without capital gains or losses, if the amount shown on Line 17 is not more than the amount of income required to be distributed currently shown in column 3 of Schedule C (less the total amount shown in column 10, Schedule C) then the amount shown on Line 17 can be entered on Line 18. Zero is entered on Line 24 and Lines 25 through 33 need not be completed. It is not necessary to fill in the additional schedules, Schedules F, G and H.

The short-form method may also be followed where there is tax-exempt income. Figure 2 illustrates the second example mentioned above. If in addition to the $5,000 in dividends and $6,000 in taxable interest there were $5,000 of tax-exempt interest, the amount of income required to be distributed currently would be $15,000, if the fee of $1,000 is chargeable to trust income. Tax-exempt income is income for trust accounting purposes and is reflected in the $15,000 figure in column 3 of Schedule C. $312.50 of the fee must be eliminated from Schedule A because attributable to tax-exempt income. The amount of the fee deductible is $687.50 rather than $1,000.

Figure 2 shows the effect of the apportionment of the fee between taxable and tax-exempt income. The adjustment made on Schedule A is reflected on Line 15 on page 1 of the return, and as a result, the amount on Line 18 is $10,312.50 rather than $10,000. The amount of income required to be distributed cur-

Long Form for Simple Trust with Capital Gains

Line		*Figure 5*
1.	Dividends (full amount before exclusion)	50,000
6.	Gross rents and royalties	25,000
8b.	Net gain from sale of capital assets	15,000
10.	Total Income	90,000
15.	Other deductions	7,925
16.	Total deductions	7,925
17.	Line 10 minus line 16	82,075
18.	Deduction for distributions to beneficiaries	67,075
21.	Long-term capital gain deduction	7,500
22.	Exemption	300
23.	Total	74,875
24.	Taxable income of fiduciary (line 17 minus line 22)	7,200

Schedule A—Explanation of deductions

Rental expenses	5,000
Trustee's fees	2,925

Schedule C — Beneficiaries Shares of Income and Credits

Column		*Beneficiary A*	*Beneficiary B*	*Total*
1. 2.	Name and address			
3.	Amount of income required to be distributed currently	46,200	46,200	92,400
5.	Domestic dividends qualifying for credit	25,000	25,000	50,000
7.	Income taxable to beneficiaries less portion in 5 and 10	8,537.50	8,537.50	17,075
10.	Tax exempt income			24,025
13.	Depreciation and depletion	2,500	2,500	5,000

Schedule G — Computation of Distributable Net Income

Line		
1.	Line 17, page 1	82,075
2.	Add: (a) Tax exempt income	24,025
3.	Total	106,100
4.	Net gain from sale of capital assets	15,000
5.	Distributable net income	91,100

Schedule H — Computation of Distributions Deduction

Line		
1.	Total of columns 3 and 4 Schedule C	92,400
2.	Total of column 10 Schedule C	24,025
3.	Balance	68,375
4.	Distributable net income	91,100
5.	Total of lines 2a and 2b Schedule G	24,025
6.	Balance	67,075
7.	Distributions deduction (lesser of 3 or 6)	67,075

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rently set forth in column 3 of Schedule C is $15,000. The instructions require that the total amount shown in column 10, Schedule C, must be subtracted from the amount of income required to be distributed currently before such amount is entered on Line 18. In this case $4,687.50, tax-exempt income minus the portion of the fee allocable to it, is subtracted from $15,000 and then $10,312.50 is entered on Line 18 as the deduction for distributions to beneficiaries. This amount may be subtracted from the amount on Line 17 and zero may be entered on Line 24.

The conduit principle

Schedule C is designed to reflect the conduit principal.[25] Columns 5 through 10 reflect the different types of income which may be attributable to a beneficiary and it is designed in such a way so that the income of the beneficiaries will be shown to have the same character in their hands as in the hands of the trustee. This schedule is used to divide up the various types of income between beneficiaries and indicates how much of each type of income is allocable to the several beneficiaries.

In the above examples we are dealing with only one beneficiary, but the Schedule C in each case shows the composition of the income attributable to him. In the first example (Figure 1), the amount of income required to be distributed currently was $10,000 and it was considered to consist of $5,000 of dividends qualifying for the credit and $5,000 of taxable interest. The total shown in columns 5 through 10 may not exceed the amount of income required to be distributed currently for a simple trust. Consequently, although the dividends were reflected in full, the interest was reduced by the trustee's fee of $1,000 before it was entered in column 7. The Regulations[26] permit the allocation of the deduction to the various types of income as the trustee elects except that a pro rata share of expense attributable in part to tax-exempt income must be allocated to it. It is necessary that an expense directly related to the particular type of income be allocated to such type; for example, real estate taxes should be allocated to real estate or rental income to the extent thereof, with only any excess being allocated to other types of income. An item such as a trustee's fee, however, should be allocated in the manner which is most advantageous to the beneficiaries. If allocated as was done in Figure 1, the beneficiary would have no reduction in the amount of dividends qualifying for the credit and he may take a 4% credit for the entire $5,000 in dividends. Here the fee was allocated entirely against taxable interest and not against dividends.

In the second example (Figure 2), it was necessary to allocate a portion of the fee against tax-exempt income, but the entire balance of the fee could be allocated against taxable interest and no part of it had to be allocated against domestic dividends qualifying for credit.

Deductions charged to trust corpus

Before the 1954 Code was enacted, the deductibility of an expense item depended in part upon whether the item was chargeable to trust income for trust accounting purposes and, in effect, reduced the amount of trust income available to the current income beneficiary.[27] Under present law, however, the beneficiary may receive the benefit of such an expense item even though it is charged to trust corpus and does not reduce the amount of trust income available to him.[28] This is illustrated by Figure 3, which also is based on a simple trust, and the short-form method is again used. There is a difference, however, for in this case the trust instrument provides that although the net income shall be currently distributable to John Doe, the beneficiary, it also provides that the trustee's customary and usual fees shall be charged to trust corpus rather than to trust income.

In this case, the language of the trust instrument requires that the fee be charged to corpus rather than to income as would ordinarily be the case if the Uniform Principal and Income Act method of allocation were followed. Here we have the same amount of income for income tax purposes as in Figure 1, $5,000 in dividends, $6,000 in taxable interest. But in this case the amount of income required to be distributed currently is $11,000, that is, the beneficiary is entitled to receive a total of $11,000 which is the net income for trust accounting purposes. It is not the net income for tax accounting purposes. He receives $1,000 more than the taxable income of the trust.

Column 3 of Schedule C reports the full $11,000, but it is still permissable to reduce the $6,000 of taxable interest by the $1,000 deduction before it is entered in column 7. In Figure 3 the aggregate amount listed in columns 5 through 7 is $10,000, the same as the amount listed on Line 17. The figure of $11,000 in column 3 of Schedule C, the amount of income required to be distributed currently, is not reduced but is left as is, but, nevertheless, the total amount that can be taxed to the beneficiaries is $10,000, and using the simple trust short-form method this amount of $10,000 is placed on Line 18 as the deduction for distributions to beneficiaries. The net effect is that the beneficiary receives $11,000 but only $10,000 is subject to income tax in his hands, $1,000 being tax-free as far as he is concerned.

The beneficiary of a simple trust may never be taxed with more than the distributable net income of a trust, nor may he be taxed with more than the amount of income required to be distributed currently. In this case the trustee's fee charged to trust corpus reduces the distributable net income to $10,000, $1,000 less than the amount of income required to be distributed currently, and as a result, distributable net income sets the maximum which could be taxable to the beneficiary.

Deductions which are properly allocable to the principal account of a trust rather than to the income account reduce distributable net income, and the benefit of the deductions is shifted to the income beneficiaries. Even if there is a capital gain, the deductions reduce distributable net income and the amount taxable to the income beneficiary and the deductions are not available against such capital gain.[29]

Figure 4 is a simple trust with two beneficiaries each entitled to one-half of the net income and capital gains are allocable to principal. The trust instrument requires that three-fourths of the fee is to be charged to trust income and one-fourth to trust principal. For *trust accounting* purposes there is $34,000 gross income, but although the trustee's

[21] In year of termination a trust is a complex trust and capital gains enter into the computation of distributable net income.
[22] 1954 Code Sec. 651, 661; Reg. 1.651(b)-1; 1.661(a)-2.
[23] 1956 Instructions for Form 1041, p. 3.
[24] The trust is assumed to be one administered under the laws of a state having the Uniform Principal and Income Act, e.g., Illinois.
[25] See S. Rep. No. 1622, 83d Cong., 2d Sess. 82 (1954), 343: "In effect, the concept of distributable net income gives statutory expression to the principle underlying the taxation of estates and trusts, that is, that these separable taxable entities are only conduits through which income flows to the beneficiaries except where income is accumulated by the estate or trust for future distribution."
[26] Reg. 1.652(b)-3.
[27] IT 3830, 1946-2 Cum. Bull. 47, 48.
[28] S. Rep. No. 1622, *supra* note 24, at 346.

fee is $4,000, the $34,000 is only reduced by $3,000 in determining the amount of income required to be distributed currently under the terms of the trust instrument. The trustee's fee of $1,000 chargeable to trust corpus does not affect the amount to which the beneficiaries are actually entitled under the terms of the instrument. The total of column 3 of Schedule C, therefore, must be $31,000, $15,500 for John Doe and $15,500 for Henry Roe, the amounts that they actually are entitled to receive under the terms of the trust agreement.

The income items from Lines 1, 2 and 4 are allocated to columns 5 and 7 of Schedule C. The full $15,000 is allocated to column 5, domestic dividends qualifying for credit, and $19,000 is allocable to column 7. Column 7 is reduced by all of the Schedule A deductions, that is, by $4,000 for a net of $15.000. The totals for column 5 and 7, that is $30,000, yield a lower figure than the $31,000 set forth in column 3, and as a result the maximum amount taxable to the beneficiaries would be $30,000 broken down as indicated, beneficiary John Doe being taxable with $7,500 of dividends and $7,500 of other income for a total of $15,000, and beneficiary Henry Roe being taxed in the same way. Each beneficiary receives $500 of tax-exempt income.

There is a long-term capital gain of $2,000, which under the terms of the trust instrument is allocated to trust corpus. Schedule C is not affected by the capital gains, inasmuch as the beneficiaries are not entitled to have the gain distributed and included in their net income. Schedule D is filled out, the $2,000 net gain is listed in 8(b) and an offsetting $1,000 long-term capital gain deduction is set forth on Line 21. Because this is a trust which under the terms of its governing instrument is required to distribute currently all of its income for the taxable year, a personal exemption deduction of $300 is allowed.

The instructions for Form 1041 permit the trustee of a simple trust with capital gains to compute the deduction for distributions to beneficiaries by totalling the columns 5 through 7 and entering the total on Line 18. Here the total of columns 5 through 7 is $30,000, and therefore $30,000 is entered on Line 18. After deducting the $30,000, the long-term capital gain deduction of $1,000, and the $300 exemption, $700 remains taxable as income to the fiduciary. In effect, this figure is really the $2,000 net capital gain figure reduced by $1,000 and further reduced by $300. The only income taxable to the fiduciary in this example would be the capital gain against which there is the offsetting capital gain deduction and the $300 exemption. The trustee's fee, although chargeable in part to trust corpus, does not reduce the amount taxable to the trustee.

Long-form method for simple trust

Let us now turn to a slightly more complex example and follow through on the long-form method of computing the tax for a simple trust with capital gains, using an example from the Regulations.[30]

Under the terms of a simple trust, all the income is to be distributed equally to beneficiaries A and B and capital gains are to be allocated to corpus. During the taxable year, the trust had the following items of income and expense:

Rents	$25,000
Dividends of domestic corporations	50,000
Tax-exempt interest on municipal bonds	25,000
Long-term capital gains	15,000
Taxes and expenses directly attributable to rents	5,000
Trustee's fees allocable to income account	2,600
Trustee's fees allocable to principal account	1,300
Depreciation	5,000

The income items are listed on Lines 1, 5 and 8(b) on page 1 of Form 1041. (See Figure 5). The capital gain is listed on Schedule D. The expenses are listed on Schedule A and also summarized on Line 15 of page 1. After Lines 1 through 17 are filled in, the income of the trust for fiduciary accounting purposes is computed and entered in column 3 of Schedule C. In this case the amount is $92,400, one-half of which, $46,200, is currently distributable to each beneficiary. The portion of the trustee's fees allocable to the principal account is not taken into consideration nor are the long-term capital gains or depreciation, in figuring the income of the trust for *trust accounting purposes.* Fees have been adjusted for tax-exempt interest and the figure of $92,400 includes the tax-exempt interest which is allocable to the beneficiaries.

Using the long-form method, the next step is to compute the distributable net income of the trust. This is done in Schedule G by taking the amount from Line 17, page 1, and adding tax-exempt interest as adjusted for expenses allocable to it. Inasmuch as tax-exempt interest represents one-fourth of the income entering into distributable net income, one-fourth of the trustees' fees must be deducted from the $25,000 figure and only $24,025 used in the computation of distributable net income. From a total of these two figures, $82,075 and $24,025, we subtract capital gain allocable to corpus, which gives the distributable net income figure of $91,100. In making the computation, expenses allocable to corpus are taken into account. In other words, in computing the income for *trust accounting purposes,* that is, figuring the amount of income required to be distributed currently, and entered in column 3 of Schedule C, trustees' fees charged to corpus are ignored. However, in computing *distributable net income,* trustees' fees chargeable to corpus are not to be ignored. It should be noted that distributable net income of $91,100 is equal to the totals of columns 5, 7 and 10; distributable net income, here $91,100, pro-

[30] The advisory group appointed by the Subcommittee on Internal Revenue Taxation to study subchapter J of the Internal Revenue Code of 1954, relating to the income of estates and trusts, has recommended that Sec. 643 be amended so that the benefit of deductions properly allocable to the principal account would not be shifted to the income beneficiary when sufficient gross income remains taxable to the fiduciary to absorb them.

[31] Reg. 1.652(c)-4.

[32] "If the estate or trust pays, credits, or is required to distribute to beneficiaries amounts other than income which is required to be distributed currently, paragraph (2) provides that these other amounts (subject to the provisions of Sec. 663) are includible in the gross income of the recipient beneficiaries but only to the extent of each beneficiary's proportionate share of the distributable net income (reduced by the amount of any income required to be distributed currently). The effect of the latter reduction is to insure (except as otherwise provided in subpart D) that recipients of other distributions are subject to tax on such distributions only if the amount of income required to be distributed currently fails to exhaust the distributable net income of the estate or trust." S. Rep. No. 1622, *supra* note 24, at 349.

[33] 1954 Code Sec. 642(h); Reg. Sec. 1.642(h)-1 - 1.642(h)-5.

[34] Reg. Sec. 1.642(c)-1 - 1.642(c)-3.

[35] 1954 Code Sec. 665-668; Reg. Sec. 1.665-1 - 1.668(b)-2.

[36] An accumulation distribution of a trust is the amount (but only if more than $2,000) by which any *amounts properly paid or credited or required to be distributed* exceed distributable net income reduced by any amount of income required to be distributed currently. In determining the excess of distributions over distributable net income (less the amounts of income required to be currently distributed) the following items are not to be considered a part of such excess: (1) amounts paid, credited, or required to be distributed, to a beneficiary as income accumulated before the birth of such beneficiary or before such beneficiary attains the age of 21; (2) amounts properly paid or credited to a beneficiary to meet the emergency needs of such beneficiary; (3) amounts properly paid or credited to a beneficiary upon such beneficiary's attaining a specified age or ages if (a) the total number of such distributions cannot exceed four with respect to such beneficiary, (b) the period between each such beneficiary is four years or more, and (c) as of January 1, 1954, such distributions were required by the specific terms of the governing instrument; and (4) amounts properly paid or credited to a beneficiary as a final distribution of the trust if such final distribution is made more than nine years after the date of the last transfer to the trust.

Complex Trusts

Line		*Distribution falls into Second Tier* ***Figure 6***	*Trustee has share of dividend credit* ***Figure 7***		*Termination* ***Figure 8***
1.	Dividends (full amount before exclusion)		1,200		10,000
2.	Interest on bank deposits, notes, corporation bonds, etc.	6,000	2,000		5,000
10.	Total income	6,000	3,200		15,000
15.	Other deductions	400	500		18,000
16.	Total	400	500		18,000
17.	Line 10 minus line 16	5,600	2,700		—3,000
18.	Deductions for distributions to beneficiaries	5,600	1,800		
19.	Adjustment of dividend exclusion		16.67		
22.	Exemption		100		
23.	Total 18 to 22	5,600	1,916.67		0
24.	Taxable income of fiduciary	0	783.33		0
	Computation of Tax				
25.	Tax on amount on line 24			156.67	
29.	Fiduciary's share of dividend received credit			15.33	
32.	Balance of tax			141.34	
	Schedule A—Explanation of Deductions				
	Trustee's Fee	400	500		
	Trustee's Termination Fee (charged to corpus)				18,000

Schedule C—Beneficiaries Shares of Income and Credits

Column		*Beneficiary C*	*Beneficiary D*	*Beneficiary E*	*Beneficiary F*	*Beneficiary G*	*Beneficiary H*
3.	Amount of income required to be distributed currently	4,000		900	900	5,000	10,000
4.	Other amounts paid, credited or otherwise required to be distributed		2,000			⅓ corpus	⅔ corpus
5.	Domestic dividends qualifying for credit			400	400		
7.	Income taxable to beneficiaries (less portion reportable in 5)	4,000	1,600	500	500	—1,000	—2,000

Schedule E—Fiduciaries Share of Dividend Credit

Line				
1.	Total domestic corporation dividend qualifying			1,200
2.	Beneficiaries share of dividends from Schedule C		800	
3.	Adjustment of dividend exclusion		16.67	
4.	Total			816.67
5.	Fiduciary's share of dividends subject to credit			383.33
6.	Enter: (a) 4% of line 5		15.33	
	(b) Tax on line 25		156.67	
	(c) 4% of line 24		31.35	
7.	Enter smallest of amounts on 6(a) (b) and (c)			15.33

Schedule G—Computation of Distributable Net Income

Line		
1.	Line 17, page 1	5,600
5.	Distributable net income	5,600

Schedule H—Computation of Distribution's Deduction

1.	Total of 3 and 4 Schedule C	6,000
3.	Balance	6,000
4.	Distributable net income (line 5, Schedule G)	5,600
7.	Distributions deduction (lesser of 3 and 6)	5,600

vides the top limit on the amount which may be taxable to beneficiaries, but included in figuring this limit is the tax-exempt income here in the amount of $24,025.

Schedule H is filled out by taking the lower of: (1) column 3 of Schedule C minus tax-exempt income, or (2) distributable net income minus tax-exempt

income, for figuring the distributions deduction. The distributions deduction here is $67,075, which is entered in Line 18. This is the maximum amount which may be taxed to the beneficiaries. Although the beneficiaries receive $92,400, only $67,075 is considered as taxable income to them and $50,000 of the $67,075 consists of domestic dividends qualifying for the credit. In addition, each beneficiary is entitled to deduct his respective share of depreciation.

Complex trusts—the tier system

Trusts which either accumulate income or distribute corpus involve certain special considerations.

If the amounts distributed to beneficiaries exceed distributable net income, the beneficiaries may be treated differently; one may be considered as having received taxable income and the other a tax-free distribution.[31] This result may arise where one beneficiary receives first-tier distributions and the other receives second-tier distributions. A beneficiary receiving income required to be distributed currently is considered to be in receipt of first-tier distributions, and a beneficiary receiving discretionary payments, second-tier.

Figure 6 illustrates the income tax effect of a trust instrument which requires the trustee to distribute two-thirds of the income to beneficiary C and gives the trustee discretion to distribute up to but not in excess of the balance of one-third of the income to beneficiary D. Any income not distributed to D may be added to principal in the discretion of the trustee. Under the terms of the instrument trustee's fees are charged to principal.

The income received during the taxable year is $6,000. Under the terms of the instrument, two-thirds of the trust income or $4,000 must be distributed to beneficiary C as an amount of income required to be distributed currently. The $4,000 is entered in column 3, "Amount of Income Required to be Distributed Currently." The trustee exercises his discretion to pay beneficiary D the balance of the trust income during the year, beneficiary D receives $2,000 as another amount paid, credited or otherwise required to be distributed. Distributable net income is $5,600, the same as the amount on Line 17 in this case. This sets a ceiling of $5,600 on the amount which may be taxed to beneficiaries C and D. With a ceiling on the amounts which can be taxed to the beneficiaries of $5,600, the amounts in column 7 of Schedule C cannot exceed that amount in this case.

If there were dividend income, then it would be the sum of columns 5 and 7 rather than column 7, but here it is assumed that all of the income is taxable interest. The total in column 7 of Schedule C must in this case, therefore, be $5,600, which is allocated between beneficiaries C and D. In Figure 6, a total of $4,000 is allocated to beneficiary C and only the balance of the $5,600 to beneficiary D. Where an amount of income is required to be distributed currently and during the same year other amounts are paid, credited or otherwise required to be distributed, distributable net income is allocated to beneficiaries receiving income required to be distributed currently before any allocation is made to beneficiaries receiving discretionary distributions. Here beneficiary C is taxed with a full $4,000, but beneficiary D receives the full benefit of the $400 expense item, even though it does not reduce the amount he actually receives. He need only report $1,600 in his income tax return.

This is an important principle when it comes to drafting a trust instrument. It is often preferable to have beneficiaries in low income tax brackets as persons to whom income is required to be distributed currently and beneficiaries in high income tax brackets as persons to whom discretionary payments are to be made. With that type of arrangement, the higher income tax bracket beneficiaries may well be able to receive the benefit of the trust expenses, in the form of tax-free income.

Figure 7 illustrates the computation of the trustee's share of the dividend credit in a complex trust. This is a trust with two beneficiaries, each beneficiary being entitled to one-third of the net income and one-third of the income is accumulated and is taxed to the trust. Dividends amount to $1,200 and interest income to $2,000 for a total income of $3,200 against which there is a fee charged in the amount of $500. The fee is charged against income for trust accounting purposes and each beneficiary is entitled to one-third of $2,700 or $900. The figure of $1,800 is entered in column 3 of Schedule C as the amount of income required to be distributed currently. This is not a discretionary trust, otherwise such amounts would be entered in column 4 rather than in column 3, for under the terms of the instrument two-thirds of the income *must* be paid out to the beneficiaries and divided equally between them. Columns 5 through 7 of Schedule C show the total amount taxable to the beneficiaries in this case and the different types of income which are reportable by them. The ceiling on the amount taxable to them is set by the figure of $1,800, the amount of income required to be distributed currently.

Schedule E is filled out by first entering $1,200 on Line 1. Of the total dividend income of $1,200, the beneficiary's share of the dividend income is two-thirds or $800, entered on Line 2. An adjustment is then made for the dividend exclusion in the amount of $16.67. This amount is figured in the following manner. There should be entered as an exclusion the first $50 of dividends received from domestic corporations during the taxable year, *reduced* by an amount which bears the same ratio to $50 that the total dividends allocated to beneficiaries in column 5, Schedule C, bear to the amount on Line 1, page 1,

Throwback Rule — Schedule J

		Figure 9
1.	Accumulation distribution in 1957	22,000
	Computation of amounts deemed distributed to beneficiaries	
		Col. A
		1956
2.	Undistributed net income	12,840
3.	Throwback (line 1 but not more than line 2)	12,840
4.	Income tax (imposed on trust) applicable to amount on line 3	7,260
5.	Income deemed distributed to beneficiaries (line 3 plus line 4)	20,100
15.	Tax credits allocable to beneficiaries	7,260
	Beneficiaries' shares of income and credits	
16.	Theodore T. Throwback, III	
17.	4321 S. Mirequag Road Acreblack, Ohio	
18.	Income taxable to beneficiaries	20,100
25.	Throwback tax credit	7,260

of Form 1041. Here the $50 exclusion is reduced by two-thirds since two-thirds of the dividend income is allocated to the beneficiaries, and the figure of $16.67 is entered on Line 19 on page 1 and also entered on Line 3 of Schedule E. The beneficiaries' share of the dividends, $800, and the trustee's portion of the dividend exclusion, $16.67 are subtracted from $1,200, which leaves the amount of $383.33 as the fiduciary's share of dividends subject to credit. 4% of this amount is the amount of the trustee's share of the credit, that is $15.33, and the trustee's tax is reduced by that amount.

Excess deductions on termination

Unused loss carryovers and excess deductions on termination are available to the beneficiaries succeeding to the trust property.[32] If on the termination of a trust, the trust has (1) a net operating loss carryover or a capital loss carryover, or (2) for the last taxable year of the estate or trust, deductions in excess of gross income for such year, then such carryover or such excess, is allowed as a deduction, to the beneficiaries succeeding to the property of the trust.

Figure 8 illustrates the effect of excess deductions in year of termination. Assume that a trust has $10,000 worth of dividend income and $5,000 of taxable interest income for a total of $15,000. It is the year of termination and a termination fee of $18,000 specifically authorized under the terms of the trust agreement, is charged by the fiduciary to trust corpus. The beneficiaries succeeding to the property of the trust are G and H, G receiving one-third of the trust corpus and H two-thirds of the trust corpus. The column—Amount of income required to be distributed currently"—is not affected by the fact of termination, $15,000 being income required to be distributed currently to the beneficiaries. The entire trust estate is distributable and the fractional shares of the trust corpus may be reported on column 4. The item of expense in the amount of $18,000 when allocated to Schedule C eliminates all items of income from columns 5 and 7 and the result is a negative figure. The instructions for Form 1041 indicate that negative figures may not be used except in the case of unused loss carryovers and excess deductions on termination. Inasmuch as there is here an excess deduction on termination, the negative figure should be reported as indicated in Fgure 8. Deductions to the beneficiary of $1,000 and $2,000, respectively, would be available.

If a charitable deduction is claimed, Schedule F of Form 1041 should be completed. A deduction is allowed for amounts paid or permanently set aside for charitable purposes. Amounts so paid or set aside are considered to consist of pro rata protions of the various classes of income received by the trustee, and if such amounts include tax-exempt income, then in computing the deduction allowable, the pro rata share of tax-exempt income is excluded.[33] If the amounts so paid include long-term capital gain, an adjustment may be required for the long-term capital gain deduction.

For example, if one-third of the income of a trust is distributable to John Doe and two-thirds to charity, if the trust has taxable bond interest of $9,000 and tax-exempt interest of $3,000, the charity is assumed to have received $6,000 of taxable bond interest and $2,000 of tax-exempt interest. The charitable deduction would be $6,000.

Distributions by a complex trust of its distributable net income for the current taxable year (if over $2,000), will be "thrown back" to each of the five preceding years in inverse order and will be taxed to the beneficiaries to the extent that the distributable net income of those years was not, in fact, paid, credited or required to be distributed. This throwback provision applies only to accumulations of income in taxable years beginning after December 31, 1953.[34]

An accumulation distribution of a trust for any taxable year is the amount by which other amounts paid, credited or otherwise required to be distributed for such taxable year (column 4 of Schedule C) exceed distributable net income (Schedule G) reduced by any amount of income required to be distributed currently for such taxable year (column 3 of Schedule C).[35]

In order for the throwback rule to come into play, there must first be an accumulation. Assume that trust income is accumulated for the year 1956, and that there is income in the amount of $21,000, against which a fee of $900 and a $100 exemption is taken for a net amount accumulated of $20,000, which is subject to tax of $7,260. Distributable net income for 1956 is computed at $20,100. This is, in effect, the net income before the $100 exemption and before taxes.

In 1957 the trustee in his discretion distributes $40,000 of income and principal. During the year 1957 there is net income of $18,000, and here equal to distributable net income. The beneficiary receives $40,000, and inasmuch as no income is required to be distributed currently, the entire $40,000 is entered in column 4 of Schedule C, "Other amounts paid, credited or otherwise required to be distributed." The extent to which *current* income may be taxed to the beneficiary is $18,000, the distributable net income for 1957, but the $40,000 is considered to include income accumulated in 1956. The amount of the accumulation distribution in 1957 was $22,000, for instead of $18,000, $40,000 was distributed, $22,000 in excess of the distributable net income of the current year.

Figure 9 illustrates Schedule J, which must be filed with Form 1041 because of the accumulation distribution. In column A is listed the undistributed net income of 1956. The figure is $12,840, which is $20,100, the 1956 distributable net income, minus the 1956 taxes. On Line 4 the tax attributable to the $20,100, that is the figure of $7,260, is entered. The result is that the full amount of $20,100 is thrown back to the year 1956 and the beneficiary receives a maximum throwback tax credit of $7,260. In this case, the entire distributable net income of the prior year is thrown back, and the entire tax credit is available. The amount thrown back to a particular year cannot exceed the distributable net income of that year.

This discussion has been designed to illustrate some of the new terms and principles affecting trust income tax returns. There are, of course, many refinements in Subchapter J and problems of considerable importance, but which are beyond the scope of this article. ☆

New trusts & estates decisions

Existing trust used for business may be taxed as corporation. Where individuals convey property to an existing trust to carry on a joint enterprise for their joint benefit, the trust may constitute an association taxable as a corporation even though the beneficiaries had no part in establishing the trust and are

without power to modify or terminate it. *Rev. Rul.* 57-534.

All income from trust taxable to beneficiary; he had no duty to use it for others. Taxpayer's wife had provided by will that a trust be created to pay taxpayer an annual net income of $25,000. The will said it was the wife's desire (but added there was no obligation) that taxpayer use the income to maintain the family home for himself and his daughters. Taxpayer claimed that the will gave him this $25,000 income in a fiduciary capacity and that any income expended on the daughters should not be taxed to him. However, the court disagrees and holds him taxable on all of the income received because he failed to prove that the cost of maintaining a home for himself did not at least equal in each year the total amounts received under provisions of the will. *Osborne,* TCM 1957-199.

New estate & gift decisions this month

Wife paid premiums on insurance policies: proceeds not includible in his estate (Old Law). Approximately 11 months prior to his death in 1952, the decedent took out $100,000 of life insurance, naming his wife as beneficiary. She possessed all of the incidents of ownership in $50,000 of the insurance, but the Commissioner nonetheless included it in the decedent's gross estate on the ground that insufficient proof had been submitted that the premiums had been paid from the wife's separate funds. The court holds on the evidence that the wife had in fact paid the premiums and that the proceeds were not includible. *Klein* TCM 1957-176.

Service insurance proceeds may qualify for marital deduction. The proceeds of life insurance policies issued under the World War Veteran's Act of 1924, or the National Service Life Insurance Act of 1940, qualify for the marital deduction, provided such proceeds are payable in a lump sum or in monthly installments with any balance at the surviving spouse's death payable to her estate. Since neither of these modes of settlement is available under the provisions of the Servicemen's Indemnity Act of 1951, proceeds payable under that Act will not qualify. *Rev. Rul.* 57-423.

Marital deduction allowed though income during administration goes for expenses. A direction in a will that income received during the period of administration from property passing to the surviving spouse be used to pay administration expenses will not result in a denial of the marital deduction, although the amount of the deduction will be reduced thereby. The surviving spouse is under the circumstances entitled to all of the income from the property passing to her, despite the fact there is necessarily some postponement of the time of the payment of such income. *Spec. Rul.,* 9/20/57.

Power to invade costs estate charitable deduction. Decedent's will established a trust, the income from which was payable to his wife and sister, the remainder to go to three admitted charities. The trustee was also authorized to invade corpus for the benefit of the life beneficiaries for their comfortable maintenance, welfare, support or in case of emergencies. The court holds that the charitable deduction is not available to the estate because of the possibility, not so remote as to be negligible, of the depletion of the remainder interest. The standard imposed upon the trustee was not sufficiently fixed in fact to permit a reasonably accurate valuation of the charities' interest. *Koinen Estate,* 16 TCM 1957-165.

Authority to invade does not defeat charitable deduction. Decedent's will made provision for the establishment of a trust to pay an annuity of $5,000 to a 78-year-old brother for life, the remaining income, and eventually the corpus, to be distributed to admitted charities. The trustees were also authorized to pay to the brother, out of income or principal, sufficient funds to provide for any "emergency, illness or necessity." The brother's net worth, including property jointly owned with his wife, was in excess of $75,000. His annual income had been only slightly less than his annual living expenses prior to the gift in question. The court holds that the remainder interest is available for the charitable deduction. Measurable standards limited the trustees' power of invasion, and although the possibility of invading the charities' income interest is not so remote as to be negligible, the same cannot be said of the possibility of an invasion of their interest in corpus. *Lee Estate,* 28 TC No. 147.

Prior return by wife does not bar later one splitting gifts. Taxpayer's wife had filed a gift tax return, prepared for her by her son by her first marriage, reporting gifts which she had made during the year but prior to her marriage to the petitioner. On the taxpayer's own gift tax return, she consented to be considered as making one-half of the gifts made by the taxpayer. The wife's consent was timely signified on his return, since the earlier return filed in the wife's name did not relate to gifts by a "spouse" and could not have misled the Commissioner. *Frieder,* 28 TC No. 146, 9/27/57.

Legal life estate with power to consume does not qualify for marital deduction. Decedent left all of his property to his wife "to be used as she pleases, for her own support, the residue after her life, to go to" a son or grandson. Under the law of the state in which the will was probated, this form of disposition created only a life estate, with remainder, despite the fact that the widow could entirely consume the remainder if circumstances permitted. The marital deduction is consequently denied. The fact that the state court imposed an inheritance tax against the widow alone is not material. *Howell Estate,* 28 TC No. 142.

Bequest to all students in school not deductible as charitable. Decedent bequeathed the residue of his estate in trust to pay a certain sum to all students enrolled at a particular school as of a particular date. The gift is not deductible as a bequest for educational purposes unless the will as a whole may fairly be read as creating a trust for educational purposes for the benefit of a general class, as distinguished from mere benevolence. *Rev. Rul.* 57-449.

Local law permits deduction of widow's allowance. (Old Law). The law of Tennessee entitles a widow to a year's support whatever the provisions of her husband's will. It follows, the court holds, that this allowance is deductible as an expense of the decedent's estate. [Under the 1954 Code no estate tax deduction is permitted for a support allowance.—*Ed.*]*Haas Estate,* DC Tenn., 5/31/57.

NEW DEVELOPMENTS IN

State & local taxation

EDITED BY JOSEPH P. STAPCHINSKAS

Georgia Supreme Court holds for Stockham in appeal on constitutional grounds

by **PETER G. DIRR**

THE STOCKHAM VALVES cases are building up quite a history for themselves in the Georgia courts. Now, the Supreme Court of the State of Georgia has reversed a lower court's findings and held for the taxpayer. On July 19 of this year the Superior Court of Fulton County rendered a decision in favor of the state. The taxpayer proceeded with an appeal and on November 8 the Supreme Court held that the attempt by the State of Georgia to assess the income tax against this taxpayer violated the due process law of the Federal Constitution (Fourteenth Amendment) as well as represented a direct interference with and burden on interstate commerce. The final paragraph of the court's decision makes interesting reading:

"As already pointed out by the United States Supreme Court, its decisions dealing with the problem here presented are spread through hundreds of volumes of its reports, and all of its pronouncements are not consistent or reconcilable. To attempt to harmonize all that has been said would neither clarify what has gone before nor guide the future, and to undertake here to point out the distinguishing features of each of the numerous decisions would only consume unnecessary time and space."

Earlier action for refund of tax

In 5 JTAX 58 we reported an earlier *Stockham Valves & Fittings, Inc.* case in which the taxpayer had initiated action against the State of Georgia to secure refund of income taxes claimed to have been assessed on income derived solely from transactions in interstate commerce for the years 1949 and 1950.

After such action had begun, the Georgia Department of Revenue requested dismissal of the suit and refunded the taxes in question. At the time, however, the department emphasized that the withdrawal from the *Stockham* case did not set any precedent for any other taxpayer or even for the same taxpayer insofar as any other years were concerned. The Georgia Department of Revenue then proceeded against the Stockham Valves & Fittings Company and levied assessments for the years 1952, 1954 and 1955.

The operations of Stockham Valves and Fittings, Inc. represented those of an out-of-state company with headquarters in Birmingham, Alabama, having a sales service office in Georgia staffed by a sales representative and a secretary and maintained solely for sales promotional purposes and goodwill. The principal duties and activities of the sales representative were to keep in touch with contractors and users of pipe fittings and valves and to furnish technical information about petitioner's products, and to encourage the specifying of its products in orders to wholesalers and jobbers. Thus, his job was to maintain goodwill among customers and members of the contracting and building trades who used Stockham products. In no case, however, did this representative or his clerical assistant have authority to, or in fact did, confirm or accept orders, arrange credit terms, make collections, or final arrangements with customers in the state of Georgia. All orders of goods from Georgia customers were subject to approval and acceptance at the Alabama offices of Stockham, and the goods were shipped in interstate commerce to the purchasers in Georgia by common carrier f.o.b. the factory or warehouse in Alabama.

Accordingly, the Stockham Company contended that it did not carry on in Georgia any activities or operations rendering it liable to pay Georgia income taxes, and that it did not receive any net income from property owned or business done in that state, and that the taxes assessed were illegally collected and should be refunded, with interest. In this connection the period of limitations in the Georgia statute requires that to obtain refund of taxes illegally or erroneously collected the taxpayer must file claim for refund within three years after payment of the tax, and actions for refund must be filed within two years from the time the claim for refund is denied.

The petitions of the Stockham Company therefore maintained that the collection of taxes from it was illegal under Section 92-3113 of the Georgia Code on two grounds. That section, it will be recalled, provides that any foreign corporation shall be deemed to be doing business within the state if it engages in any activity or transaction for financial profit or gain within the state, regardless of whether or not it maintains an office or place of business in Georgia or that any of its activities or transactions are connected with interstate or foreign commerce.

Grounds for appeal

This widesweeping declaration of "doing business" in Georgia with probable tax liability was attacked in the petitions as illegal and invalid on the grounds that:

1. The statute is in violation of the Fourteenth Amendment to the U. S. Constitution, in that it authorizes the state to tax a foreign corporation which is not actually present or doing business in the state, on taxable events not occurring in Georgia, and to measure the tax by sales or transactions conducted entirely without the limits of Georgia constitutes a denial of due process of law, and

2. Since the Act authorizes Georgia to levy a tax on income derived from sales consummated entirely in interstate commerce, it constitutes a direct interference with and a burden on interstate commerce in violation of the Commerce Clause.

Perhaps more clarification will be forthcoming when the U. S. Supreme Court reviews the case of the *Northwestern States Portland Cement Company* case in which case the Minnesota Supreme Court, under circumstances

quite similar to those prevailing in Georgia in the *Stockham Valves* case, reached a different conclusion and upheld the state's assessment against the taxpayer. In this case the Minnesota Supreme Court pointed out that the Supreme Court of the United States had on a number of occasions indicated that a state tax on net income from interstate commerce, as distinguished from a tax on the privilege of engaging in interstate commerce, is not in violation of the commerce clause of the Constitution, provided such tax is nondiscriminatory, fairly apportioned, and does not impose an undue burden on interstate commerce. Admitting that all local activities of the taxpayer such as resident salesmen, local office and solicitation of customers were an integral part of interstate commerce, the court held that they represented "localized" aspects of the taxpayers' business and that the tax assessed against the proceeds of interstate commerce was valid.

This decision was handed down on June 14 of this year, affirming a decision of the Hennepin County District Court. The taxpayer applied to the Minnesota Supreme Court for a rehearing which was denied and now an appeal has been filed with the U. S. Supreme Court.

Perhaps when this highest tribunal reviews the *Northwestern* case there will be some clarification as to the power of the states to tax interstate commerce. ☆

New state & local decisions

Out-of-state destination no bar to gross income tax. Under prime contracts with the United States (and sub-contracts with other prime contractors of the Government) taxpayer manufactured goods in Indiana and delivered them to carriers at its local plant for transportation via Government bill of lading to extra-Indiana destinations. Title to and possession of the goods, as well as control of their movement, passed from taxpayer to the Government at the time of loading on the carriers. Viewing the carriers as agents of the Government, the Court holds that the imposition of gross income tax was not inhibited by the Commerce Clause, the receipt resulting "from transactions completely performed in Indiana." *Bendix Aviation Corp.*, Sp. Ct. Ind., 6/5/57.

Out-of-state royalties income taxable. Taxpayer, an Idaho resident, received royalties from oil producing lands located in Wyoming. He argued that assessment of income tax on the royalties was illegal because it represented an attempt to tax Wyoming land. The court dismissed this contention on the basis that the state's income tax was an excise measured by net income and not a tax on the property from which income was derived. While Idaho law exempts income of residents derived from trades or businesses carried on outside the state, the court held that this provision was not applicable since the mere ownership of property could not be regarded as engaging in business. The royalties arose from an oil and gas lease which as intangible personal property had its taxable situs at the domicile of the owner, the court ruled. Two judges dissented from the majority opinion. The dissent contended that the royalties in the case were taxable in Wyoming, and that since legislative policy contemplated equal treatment of resident and nonresident, the effect of the ruling was to prohibit Idaho from taxing the rents and profits from real estate owned by nonresidents. It asserted that neither this interpretation nor the double taxation which it held would result from the decision should be ascribed to the legislature. *Kopp. v. Baird*, Sp. Ct. Idaho, 6/25/57.

Rental company not retailer; sales to it taxable. Taxpayer manufactured uniforms and work clothing which it sold to a company which rented them to its customers. It argued that the sales to the rental company were not subject to sales tax because they were made to a licensed retailer. The court, however, held that by statutory definition a retailer had to operate a regularly organized retail business, maintain a store or make sales to the public as a transient vendor. Since the company purchasing the uniforms rented them rather than sold them to its customers the court held it was excluded from the definition of retailer under the act and that the manufacturer was therefore taxable on the sales. *N&W Industries, Inc.*, Sp. Ct. Miss., 3/18/57.

Gross receipts tax on advertising solicited locally upheld. Taxpayer-magazine was managed and edited in New York City, but was printed in Connecticut by an independent printer on a contractual basis. Advertising was solicited by offices in New York and Chicago. In imposing the gross receipts tax, the city included proceeds of advertising sold through the New York office. The court held the case was governed by the Supreme Court decision in *Western Live Stock*. There the Court had held that the business of preparing, printing, and publishing magazine advertising was peculiarly local and distinct from its circulation whether or not that circulation was interstate commerce, and that the entire gross receipts therefrom were taxable by the state where the preparation, printing and publishing were performed. The New York court found only one real distinction between the case on hand and *Western Live Stock*. In the earlier case the magazine was printed in the taxing state while in the instant case the printing was done out-of-state. The court, however, held that this distinction did not give the taxpayer's business an interstate character since the plant at which the printing was performed was not owned by the taxpayer. *New Yorker Magazine*, N. Y. Ct. App., 7/3/57.

Virginia-Kentucky Compact of 1789 bars Kentucky tax. Taxpayer was a common-carrier water-transportation company handling freight-for-hire on the Ohio River. It neither owned nor leased property in Kentucky, had no employees there and was not qualified to do business in the state. In transporting freight, the taxpayer navigated the Ohio River between the Kentucky and Ohio shores. Kentucky attempted to impose a tax on the carrier's franchise. The levy was construed by the state as an ad valorem tax on intangible property but was declared invalid by the Kentucky Court of Appeals which held that the only intangible value allocable to Kentucky was its right to navigate the river. In 1789, the "Virginia-Kentucky Company" legislation was passed by Virginia to enable the territory of Kentucky to be admitted to statehood. Under the compact, "the use and navigation of the river Ohio" were to be "free and common to the citizens of the United States." Construing the instant tax to be imposed on the right of the carrier to use the Ohio River, the Court held the exaction unconstitutional. *Ohio River Co.*, Ky. Ct. App., 6/21/57.

TAXATION OF

Partnerships

EDITED BY JACKSON L. BOUGHNER, LL.B., CPA

Watch out for trouble areas in Code provisions on partnership taxation

by J. LITTLETON DANIEL

As tax men work with the partnership provisions of the Code, the ramifications and implications of those elaborate rules become clearer and they can see the practical importance of coming under or avoiding particular provisions. Mr. Daniel discussed some of the areas he has found most troublesome—negative basis interests, shares of income, contributed property, etc., at the recent State Convention of the Oklahoma Society of Certified Public Accountants. We bring you here his treatment of some of these points.

PRIOR TO the passage of the 1954 Code, the taxation of partnership income involved a great many uncertainties. The partnership provisions of the 1939 Code, and of the various Revenue Acts, were short and covered only a small part of the subject. A large body of case law was built up over the years, but even that left many questions unanswered, in addition to presenting difficult problems of interpretation even when one could find a case which seemed to be in point. Many principles rested only upon logic and the authority of general acceptance. I think it might even be fair to say that many of our past assumptions, if properly tested, would prove to be little more than the folklore of taxation.

The 1954 Code takes us to the opposite extreme. Subchapter K, the partnership section, goes into great detail, and contains several entirely new rules. One, the limitation of distributive losses by reference to the tax basis of the partner's interest in the partnership, is already causing difficulty and has had unforeseen effects. Let me illustrate what I mean.

Suppose that Walter Ennis and I decide to form a partnership. We each contribute $5,000 in cash. Things don't go very well, and we lose the $10,000. We borrow $10,000 from a careless banker and lose that also. Our balance sheet would look like this:

Assets		*Zero*
Liabilities		$10,000
Capital		
Ennis	(negative)	$ 5,000
Daniel	(negative)	5,000
Total	(negative)	$10,000

You would say that Ennis and Daniel each have a $5,000 negative basis in their partnership interest. If we looked at Section 704(d), we might conclude that Ennis and I would each have to forego the deduction of $5,000 of our loss, since that section says a partner's share of a partnership loss shall be allowed only to the extent of the adjusted basis of his interest in the partnership at the end of the year in which the loss occurred; and Section 705(a)(2) says the basis cannot be less than zero. However, under a new concept in the 1954 Code, each partner's basis includes his share of the partnership debts. This would bring our negative bases up to zero, and we could deduct the entire loss.

Now let's change the case a little. We failed to locate a careless banker, Ennis contributes the second $10,000 himself, and we proceed to lose it. In spite of the fact that our partnership has lost the same amount of money as in the first case, my position is radically different. (I suspect that Ennis would say his is also.) Here's why: Our balance sheet in the second case looks like this:

Assets		*Zero*
Liabilities		*Zero*
Capital		
Ennis	(positive)	$5,000.00
Daniel	(negative)	$5,000.00

(Bear in mind that although we have no assets and no liabilities, we are still operating.) The difference in my case is this: Since the partnership has no debts, there is nothing for me to add back to my negative capital account, and I therefore can deduct only the first $5,000. Since Ennis still has a positive basis in his interest in the partnership, he can deduct his half of the $20,000 we lost.

I could deduct the second $5,000 of my loss in the second year if I contribute $5,000 in that year.

Actually, there is no substantial economic difference to me in the two cases. In the first, I owe one-half of the $10,000 bank loan. In the second, I owe Ennis $5,000. Yet, in the first case I can deduct $10,000 of the partnership loss, while in the second I can deduct only $5,000.

It is not unreasonable to expect that this situation may be cured by amendment to the Code, but until it is, the point should be watched. As it stands, it affords an opportunity to accelerate or defer losses by, for example, the timing of capital contributions.

Shares of income

Section 704 deals with the determination of the partners' distributive share of partnership income. With certain limitations, it provides that a partner's distributive share of income, gain, loss, deduction, or credit, shall be determined by the partnership agreement. One of the limitations is that, in the case of a family partnership, proper allowance must be made for the value of services contributed, for example, by one who has given an interest in the partnership to some other member of the family.

Still another limitation is that the principal purpose of any provision in the partnership agreement with respect to the partner's distributive share of a particular item must not be to avoid or

evade tax. The Regulations make the general requirement that such a provision must have a substantial economic effect as between the partners in order to be valid for tax purposes. For example, if a two-man partnership invests equal amounts in municipal bonds and corporate stock, and agree that one partner will get the benefit of all the income and profits on sale of the bonds, and the other will receive credit for the income and profits on sale of the stock, the arrangement has a substantial economic effect and will be recognized for tax purposes. On the other hand, if one partner gets credit for the first $10,000 of tax-exempt interest and the other the first $10,000 of dividends, with the balance divided equally, there is no real economic effect, and the arrangement will not be recognized.

The general limitation just mentioned does not apply to cases in which the partnership agreement is designed to take account of a variation between the fair market value and the tax basis of property contributed to a partnership. For example, if A and B each contribute $10,000 in cash to a partnership, and C contributes property worth $10,000 but which has a tax basis of only $4,000, it can be provided that C will report the first $6,000 of profit if the property is later sold, or that his share of the income will be adjusted to take account of the fact that allowable depreciation is based on a figure which is less than the value of the property at the time acquired by the partnership. The variation must apply *only* to depreciation, depletion, or gain or loss with respect to the contributed property.

If the partnership agreement makes no provisions regarding specific items, then all must be divided in accordance with the general profit and loss ratios specified in the agreement. This rule is itself subject to a limitation respecting undivided interests. If the agreement does not provide otherwise, depreciation, depletion, and gain or loss will be determined as if the undivided interests had not been contributed to the partnership. If A and B form a partnership, and each contributes a half interest in the same asset, depreciation would be divided in proportion to the adjusted basis of each. If A had a zero basis in his half and B had recently purchased his half interest for $40,000, then B would get all the depreciation. The undivided interest rule applies only if the partners' interests in capital and profits correspond to the undivided interests. Furthermore, all the partners must have owned such undivided interests prior to their contribution to the partnership.

So much for the distribution of income and losses. It should be said, however, that there are still further means of varying distributive shares by means of so-called special basis adjustments. We will get to them later.

Dealings between partner and firm

In general, dealings between a partner and his partnership are recognized for tax purposes to the same extent as if they took place between the partnership and one who is not a partner. Example: Taxpayer is a member of a three-man equal partnership. He sells to the partnership for $15,000 real property which has a basis of $9,000 to him. The entire $6,000 gain is taxable; he may not exclude one-third of the gain on the theory that he was dealing with himself to that extent. The same thing would be true in the case of a gain on a sale to him by the partnership. He would have to pay tax on his distributive share of the partnership's gain, even though his share of the gain is actually attributable to his interest in the property prior to the purchase.[1]

Exceptions:

1. Loss is disallowed in the event of a sale or exchange between a partnership and a partner whose direct or indirect interest in capital or profits is more than 50%, or in the case of a sale between two partnerships in which the same persons own more than 50% of the capital or profits interest.[2]

2. Capital gains treatment is denied on certain transfers between a partnership and a partner owning more than an 80% interest, or between two partnerships in which the same person owns more than an 80% interest in capital or profits.

Guaranteed payments

If a partner receives "guaranteed payments," such as a salary or interest on his capital investment, the amounts are treated as gross income of the partner and business deductions of the partnership. This contrasts with the older principle, which was that such payments were mere mechanisms for the division of profits.

It is probable that the one section which has caused more discussion among tax men than any other is Section 761, which defines partnerships. The definition covers almost any type of joint undertaking, and includes the co-ownership of oil and gas leases. It provides, however, that an organization may elect to be excluded from taxation under Subchapter K, if such organization is availed of for the joint production, extraction, or use of property, and if the income of the individual members can be adequately determined without computing taxable income of the partnership. As might have been expected, oil people and their tax advisers were unanimous in desiring exclusion. The differences in tax bases, optional methods of computing depreciation, and other considerations would have produced an almost chaotic situation, if each lease owned by more than one person were taxed as a separate partnership.

At the same time, an unsuccessful attempt to elect exclusion could have catastrophic results. Suppose A and B each expend $100,000 in intangibles in connection with the development of a lease, elect the exclusion, and deduct the intangibles in their personal returns. Suppose that they fail to make the election correctly. You can imagine their consternation, and their displeasure with their tax adviser, when the revenue agent informs them that they should have filed a partnership return, and that failure to do so amounts to an election to capitalize the $200,000 of development expenses.

As you know, the Regulations now spell out in detail the procedure for electing the exclusion. It has involved the filing of multiplied thousands of Forms 1065 containing statements of the election to exclude, and will involve the filing of many more *millions* of 1099's. Whether the administrative procedure will break down because of this great volume of renditions cannot be told.

Contribution of property

The rules which control the contribution of property to a partnership in exchange for a partnership interest are much like old Section 112(b)(5) and its opposite number in the 1954 Code, Section 351, which cover transfers to controlled corporations. Section 721 provides that no gain or loss shall be recognized on the transfer. Section 722 holds that the basis of the contributed property becomes the basis of the partnership

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interest. And, finally, Section 723 provides that the basis of the property in the hands of the partnership shall be its adjusted basis to the contributing partner at the time of the contribution.

This seems clear enough, but that is not the whole story. The Regulations hold that if A contributes money or property worth $10,000, B contributes services, and B is credited with one-half of the capital, he realizes taxable income. *When* he realizes the income depends upon when the services are rendered, and the extent of any restrictions on his capital credit. B does not get the protection of Section 721, since he contributed no capital. Incidentally, this point is in interesting contrast to the so-called "pool of capital" theory in connection with the acquisition, development, and operation of an oil property. You will recall that the theory runs to the effect that the pool of capital includes not only money but effort. If A and B engage in a joint effort to acquire and develop an oil property with A putting up the money and B the work, B is viewed as having invested time and effort in the oil property, rather than having received compensation in the form of property.

Here is another exception to the rule that transfers of property to a partnership are not taxable:

You will remember that if you transfer property to a controlled corporation in exchange for stock, and the corporation assumes a debt against the property which exceeds the adjusted basis of the property, you realize a taxable gain to the extent of the excess. The provision is designed to close the negative basis loophole, and has a counterpart in Subchapter K, although the partnership rule does not work in exactly the same way. These two cases will illustrate the difference:

Case 1: A transfers property to a corporation controlled by him. The property has a value of $50,000, a tax basis of $10,000, and is subject to an encumbrance of $30,000. His taxable gain would be $20,000.

Case 2: Assume the same transaction, except that the transfer is to a newly formed partnership between A and B. A's gain would be calculated this way:

Under Section 722, A receives a basis for his partnership interest equal to the adjusted basis of the property transferred: $10,000.

Under Section 752(b) A is considered to have received a distribution of money equal to the reduction of his debt. This reduction is not $30,000, but $15,000, since he owns a half interest in the partnership and is therefore still liable for: $15,000.

Under Section 733, a distribution of money reduces the basis of the interest in the partnership. This would produce a negative basis of: ($5,000).

However, Section 733 holds that the basis of a partnership interest cannot be less than zero, and Section 733(a)(1) says that a partner realizes gain if he receives a distribution of money in excess of his adjusted basis in the partnership interest. Therefore, A realizes a taxable gain of $5,000, leaving the adjusted basis of his interest at zero. Contrast this with the gain on the transfer to the corporation, which was $20,000. There is another significant difference between the two cases. In the case of the transfer to the corporation the gain relates to the transferred property. The gain realized on the transfer of the property to the partnership is considered to be realized on a sale or exchange of the partnership interest, which A acquired the same day.[3]

At first glance this might appear to result in a short-term gain. However, if the transferred property were a capital asset or a Section 1231 asset its holding period would carry over to the partnership interest. In the case of a contribution of appreciated inventories, the holding period cannot be carried over, and the consequences could be quite unpleasant.

This provision for the realization of taxable gain on receipt of a distribution of money or its equivalent to the extent that basis is reduced below zero, does not apply to a distribution of property. Assume you own a partnership interest at an adjusted basis of $5,000. Assume further that you receive a distribution of $4,000 in cash, and property of a value of $6,000. The cash reduces the basis of your interest to $1,000. If the distribution were a final one involving your withdrawal from the partnership, the basis of the property in your hands would be $1,000, regardless of its value. If not final, the property would have the same basis as it had in the partnership, limited however to $1,000.

The rule just described, that a partner will realize no gain on receipt of a distribution, except to the extent that the cash received exceeds the basis of his interest, has a companion. A partner will realize no deductible loss on a final distribution, unless he receives nothing but cash and the cash is less than the adjusted basis of his interest. As might be expected, we have an exception:

The collapsible partnership

The Code provides for special treatment of so-called Section 751 assets. Such assets are defined as unrealized receivables and inventory items which have appreciated substantially in value. In general, inventory items are anything which constitutes stock in trade. To meet the definition of substantial appreciation, the inventory items must have a value of more than 120% of their tax basis and their value must exceed 10% of the total value of all assets other than money. Certain distributions involving Section 751 assets are treated as sales or exchanges. We can better understand the rule if we keep in mind the fact that it is designed to close the same type of loophole as was involved in the collapsible corporation.

Tests of collapsibility

You will remember that there are two main tests to be met before a corporation can be branded with the stigma of collapsibility:

1. It must meet all the objective tests involving the nature of its assets, profits realized on liquidation or sale, et cetera.
2. There must have been an intent to use the corporation to convert ordinary income into capital gain by, for example, a liquidation when it holds substantially appreciated inventories.

In the case of the collapsible partnership, intent is not relevant. The test is purely objective.

Section 741 provides that if a partnership interest is sold or exchanged, a capital gain or loss will result, except as provided in Section 751. Section 751 holds that the proceeds of a sale attributable to unrealized receivables and substantially appreciated inventory items shall be considered as an amount realized from the sale or exchange of property other than a capital asset. This rule covers not only the sale of a partnership interest, but certain distributions. For example, if a partnership distributes Section 751 assets to a partner for all or a part of his partnership interest, the transaction is treated as a sale between such partner and the part-

nership. Furthermore, if a partnership owns Section 751 assets, and distributes *other property, including money,* to a partner for all or a part of his interest, the same treatment applies. Either transaction will bring about a redistribution of the individual partners' respective interests in the Section 751 assets, and it is the redistribution of interests which produces the tax effect. For that reason, a pro rata distribution of Section 751 assets to all partners produces no gain or loss, since there has been no change in interest. Furthermore, if the distributee originally contributed the property, no gain or loss results, since he is merely getting back what he contributed in the first place.

Section 751 distribution

Here is a case in which both the partnership and the distributee partner would realize taxable income on a Section 751 distribution. B has a 25% interest in the ABC partnership. The balance sheet is as follows:

Assets

	Adjusted Basis	*Market Value*
Cash	$12,000	$12,000
Inventory	2,000	8,000
Other property	10,000	12,000
Totals	$24,000	$32,000
Capital		
A	$12,000	$16,000
B	6,000	8,000
C	6,000	8,000
Totals	$24,000	$32,000

The inventory is Section 751 property because it is worth more than 120% of its cost, and constitutes more than 10% of the total property. The inventory is distributed to B in complete liquidation of his partnership interest. The partnership realizes a taxable gain of $4,500, computed as follows:

1. The partnership is considered to have sold a 75% interest in the inventory (not 100% since B already beneficially owned 25%). The proceeds of the sale are the property interests relinquished by B. This is 25% of the value of all the assets except the inventory: $6,000.

2. The *tax basis* of the inventory sold by the partnership is $2,000 less than the 25% interest already beneficially owned by B: $1,500.

Gain: $4,500.

The partnership's gain is ordinary income.

B has sold his interest in all the tory. His gain is computed as follows:

Sale price—market value of the 75% interest in the inventory acquired from the other partners	$6,000
Cost—his adjusted basis for the 25% interest he relinquished in property other than inventory	5,500
Gain	$ 500

You will recall that B's adjusted basis in his partnership interest was $6,000, and we charged off only $5,500 against his gain. What happened to the other $500? That is the tax basis, in his hands, of the 25% interest in the inventory which he already owned. He now has an $8,000 inventory, 25% of which he holds at a basis of $500, and 75% at a basis of $6,000.[4] There is one more question to be answered. Who reports the $4,500 of the ordinary gain realized by the partnership? The statute says that the gain is realized by the partnership as constituted after the distribution. Therefore, A and C would have to pick it up in their returns.

If you find the foregoing figures confusing it will help to recall this simple fact: B acquired the other partners' 75% interest in the inventory, in exchange for his 25% interest in all the other partnership assets. The gain in each case is computed by taking the fair market value of the property interests acquired, and reducing that figure by the tax basis of the property interests disposed of.

Optional basis adjustments

One of the most troublesome problems in the taxation of partnership income arises when the tax basis of a partnership interest differs from a pro rata share of the tax basis of the partnership assets. For example, assume that the ABC partnership owns three pieces of real estate which have a tax basis of $10,000 each, a total of $30,000, and that the tax basis of each of the three equal partnership interests owned by A, B, and C is $10,000. Now suppose that the three pieces of property increase in value by $5,000 each. This makes the total partnership assets worth $45,000, and at this point C sells his interest to D for $15,000. Without some special treatment, a subsequent sale of the real estate for $45,000 would produce a gain of $15,000, since its tax basis is only $30,000 and D would be required to report one-third, or $5,000. Actually, D has realized no economic gain, since he has in effect already paid $15,000 for his one-third interest in the realty.

Or, assume that C dies, and his partnership interest is subjected to estate tax at a value of $15,000. If the partnership then sells the real estate, C's estate would realize a taxable profit of $5,000, even though the profit has already been burdened by an estate tax.

The solution lies in an election to make an optional adjustment to the tax basis of the partnership property. Code Section 754 authorizes the election, and Section 743 provides for the manner of making it. In the case of the purchase of C's interest by D, the real estate would be written up on the books by $5,000, but the increase in tax basis would be only for the benefit of D. Then, if the real estate were sold for $45,000, the gain would be only $10,000 instead of $15,000, and would be taxable $5,000 to A, $5,000 to B, and nothing to D. The same principle applies to allowable depreciation on property which has been so adjusted. To the extent that the $5,000 write-up relates to depreciable improvements, additional depreciation would be allowable, but only for the benefit of D.

Exactly the same treatment would be permitted in the case of the transfer of C's partnership interest to his heirs, since Sections 743 and 754 apply to transfers of interests not only by sale or exchange, but by the death of a partner.

Distribution after special adjustment

Now, let's see what happens when a partnership distributes property to one or more partners after the special basis adjustment has been elected and made. Certain adjustments are required by Section 734(b). It helps to understand that section if we remember that the basic purpose of Section 754 is to permit the partnership assets to be adjusted to coincide with the partners' tax basis in their interest in the partnership. As we have already said, if D buys a partnership interest at a figure greater than

[1] CCH 1957 Partnership Income Tax Guide, page 29.
[2] CCH 1957 Partnership Income Tax Guide, page 29.
[3] Illustration taken from Arthur B. Willis, *Handbook of Partnership Taxation*, page 72.
[4] *Ibid*, page 295.
[5] *Ibid*, page 346.

his share of the tax basis of the partnership assets, we can elect to write the assets up to the extent of the excess. If a partner surrenders his interest in the partnership in exchange for some of the assets of the partnership other than money the assets take a new basis in his hands; that is, they take the same basis as his partnership interest. If the distributed assets have a tax basis of $10,000, and his partnership interest has a basis of $5,000, such assets acquire a basis of $5,000, when distributed to him. In other words, the assets lost $5,000 of tax basis when going through the nontaxable exchange, and it is therefore permitted to write up the remaining partnership assets of the same class by the same amount. The reverse is also true. If the distributed assets get an increased basis in the exchange, then the undistributed assets must be written down by the same figure.

As we have already seen, in some cases a distribution of partnership assets results in taxable gain or loss to the distributee. If there is a gain or loss on the distribution, then such gain or loss must be offset by an adjustment to increase or decrease the remaining partnership assets of the same class.

Section 734(b) adjustments

The adjustments required by Section 734(b) may be summarized as follows:

1. The tax basis of the undistributed assets must be increased in the amount of the taxable gain recognized to the distributee.

2. Their tax basis must be reduced by the amount of the deductible loss allowed to the distributee.

3. Their tax basis must be increased to the same extent that the basis of the distributed assets is reduced.

4. Their tax basis must be decreased to the same extent that the basis of the distributed assets is increased.

We can now go back to our first case, and assume that after D acquires his interest from C for $15,000, and after the special basis adjustment of $5,000 has been made, D decides to retire from the partnership, and one of the properties is distributed to him in complete liquidation of his interest. The tax basis of the property which goes to D is increased, and the above rule requires that the undistributed property be reduced by the same amount:

The basis of the property distributed to D becomes, in his hands, $15,000, since that is the tax basis of his surrendered interest in the partnership		$15,000.00
The partnership's adjusted basis in the distributed property, just before the distribution, is		
Common (original) basis)	$10,000.00	
Special basis adjustment under Section 743 (⅓rd of the $5,000 adjustment)	1,666.67	
Total partnership basis		11,666.67
Increase in basis of lands distributed to D		$ 3,333.33

The basis of the undistributed property is therefore decreased by the same amount. It will be seen that the decrease exactly equals the original write-up in the two undistributed properties, so they are right back where they started; that is, their tax basis is again $10,000 each.

Logic apparent

The logic of this situation is apparent when it is realized that D, whose acquisition of a partnership interest was responsible for the special basis adjustment in the first place, is no longer a member of the partnership and the entire special basis adjustment disappeared with him.

But what happens if A retires from the partnership instead of D, and receives one of the three pieces of real estate in exchange for the surrender of his interest? Since the basis of his interest is $10,000, and the common basis of the property in the hands of the partnership is $10,000, the only decrease in basis relates to the special basis adjustment which was attributed to the property when D came into the partnership. That adjustment is reallocated to "remaining property of a like kind," which in this case would mean that the original basis adjustment of $5,000 is still on the books, divided equally between the two properties, and still only for the benefit of D.

Arthur Willis on partnerships

Arthur Willis, in his Handbook of Partnership Taxation points out certain defects in the operation of Section 734(b) which penalize the remaining partners when a partner retires. He illustrates one situation this way:

The balance sheet of the ABC partnership is as follows:

	Adjusted Basis	*Market Value*
Assets		
Cash	$45,000	$ 45,000
Real estate		
Parcel #1	15,000	40,000
Parcel #2	12,000	35,000
Totals	$72,000	$120,000
Capital		
A	$24,000	$ 40,000
B	24,000	40,000
C	24,000	40,000
Totals	$72,000	$120,000

C sells his partnership interest to D for $40,000, and no election was filed under 754, so no special basis adjustment is made. The partnership later retires the interest of D by distributing $40,000 cash to him. D realizes no gain, because he paid $40,000 for his interest. None of the conditions specified in 734(b) are effective to adjust the partnership's basis in its undistributed property. We have, therefore, this situation: The tax basis of the remaining partnership property is $15,000 for parcel #1 and $12,000 for parcel #2, or a total of $27,000. Yet, the tax basis of the interests of the remaining partners totals $48,000. What happens to the other $21,000? Apparently, the only way the remaining partners can get any benefit from the $21,000 is to terminate the partnership. It is strong medicine which require the suicide of the patient to effect a cure.[5]

When working on partnership problems I have many times offered myself a piece of advice which you may be able to use. It is this: When a question involving the taxation of partnerships arises, never, never take anything for granted. ☆

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CORPORATE & PERSONAL PROBLEMS IN

Taxation of compensation

EDITED BY JOHN P. ALLISON, LL.B.

Compensating the corporate executive presents various tax problems

by **ROY G. MOSHER**

Some of the more popular methods of compensating executives are, practically speaking, not available for closely held firms (the restricted stock option, for example). Others may present more difficult problems for the small corporation than for the large public company (split dollar insurance plans). Mr. Mosher gives a basic review of the special advantages and hazards of compensation and fringe benefits in terms of the stockholder-executive of the closely held firm in this paper which, in slightly longer form, was presented at the 4th Annual Institute of Taxation at Houston, Texas.*

EACH OF the Federal income tax laws since the 1918 Revenue Act has specifically provided for the allowance of a deduction for all of the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered. As expressed in the Commissioner's proposed Regulations covering Section 162(a), the test of deductibility in the case of compensation payments is whether they are reasonable and, in fact, are payments purely for services.[1]

We start right off with a consideration of the subject of reasonableness of compensation paid to executives of closely held corporations, because it is basic to a discussion of all the methods of compensating these executives that will be considered. Whether payments to executives are in the form of salary payments, cash or deferred bonuses, stock purchase options, allocations under a qualified pension or profit-sharing plan, benefits received under a deferred compensation contract, or merely particular forms of fringe benefits intended as additional compensation, it is necessary that all such payments or benefits, when considered together, pass the IRS as not being unreasonable for services actually rendered. It is quite conceivable that a closely held corporation might obtain IRS approval of its qualified profit-sharing plan, only to be faced with disallowance of a portion of its annual contribution under the plan allocable to a particular executive on the ground that such allocation, when considered together with all other payments to the individual for the particular year, represented excessive or unreasonable compensation for that year.

The issue of reasonableness of compensation claimed as a deduction historically has produced innumerable disputes between taxpayers and the Service. Despite the many court decisions on the subject, it is not possible to lay down hard and fast rules as to what constitutes reasonable pay. This is because the facts in each particular case are determinative. The proposed Regulations seek to furnish broad tests or guides. Thus, they provide that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances.[2] The circumstances to be taken into consideration are those existing at the date the contract was made, not those existing when the contract is questioned.[3]

When the compensation deduction is questioned, the Service often contends that the ostensible salary represents a dividend or distribution of earnings. For this additional reason, the issue of reasonableness of compensation is particularly pertinent to a closely held corporation. In fact, the issue of reasonableness is almost exclusively in the domain of the closely held company. It is possible to go even further and to state that even the closely held corporation is unlikely to have an issue raised as to the reasonableness of compensation paid to an executive who is a nonstockholder. Most suspect and most difficult to defend are excessive salaries paid in proportion to stock holdings.

Fortunately there does appear to have been a tapering off recently in the litigation of cases involving reasonableness of compensation. We can only conjecture whether this trend indicates greater leniency on the part of the Service in dealing with the issue or greater timidity on the part of closely held corprations in claiming deductions for compensation paid to executives. It is unlikely that the latter can be responsible, since the tax advantages of deductible compensation as compared to the disadvantages of nondeductible dividends, which are taxed twice, is too tempting in most instances. Statistically, there are ample grounds for justifying very substantial increases in executive compensation by reference solely to the purchasing power of the dollar. Reliable computations indicate that a married executive without dependents who earned a salary of $30,000 per year in 1939, would have needed a salary of $140,000 in 1953 in order to make up for his loss in purchasing power.[4] This disparity increased as the salary bracket increased. These same statistics indicate that a 1939 salary of $40,000 would have been equivalent to a 1953 salary of $220,000, and that it would take a 1953 salary of $580,000 to provide the purchasing power of 1939 compensation in the amount of $60,000.[5] Of course these disparities would be even greater in 1957 than they were in 1953.

Until the Service announces a policy of recognizing diminishing purchasing power of the dollar, and it is unlikely that such a hoped-for Utopia can be

*Proceedings of the 4th Annual Institute of Taxation will be published by the JOURNAL OF TAXATION in January, 1958. It will be priced at $4.95 and may be ordered from The Journal, 147 East 50th St., New York 22.

[1] Proposed Reg., § 1.162-7(a).
[2] Proposed Reg., §1-162-7(b)(3).
[3] Ibid.
[4] *Executive Pay Plans*, William J. Casey and J. K. Lasser.
[5] See note 4, *supra*.

anticipated any time soon, there will undoubtedly continue to be a trickle of cases into the courts involving deductibility of compensation paid to executives of closely held corporations.

A review of the compensation cases reported during recent months discloses no departure from the guiding principles evolved in the long line of earlier cases dealing with the issue. One of these cases[6] illustrates the type of compensation payments previously mentioned as being most likely to be questioned. In this case all of the corporate stock was owned in equal amounts by the two principal officers. Salaries were paid to these two officers according to a formula which provided that all net profits remaining, after a 20% reserve, 6% for dividends, and payment of all taxes, would be equally divided between the two stockholders. The formula resulted in salaries of approximately $60,000 to each of the officers in one of the years involved and $50,000 in the other. The Commissioner allowed $36,000 to each officer in each year and the Tax Court increased this allowance to $45,000 per officer per year. Even in this rather flagrant case, it is interesting to note that the Tax Court increased the deduction which the Commissioner was willing to allow.

My review of other recent cases involving reasonableness of executive compensation did not turn up any that were particularly illustrative of any of the aforementioned guiding principles which have been laid down by the courts. I do believe, however, that the 1951 Tax Court case of *University Chevrolet Co., Inc.*,[7] is one case that has rather special significance to any consideration of methods of compensating stockholder-executives of closely held corporations. This case involved the deductibility of contingent compensation paid to its sole stockholder under the terms of a contract entered into with the executive several years before he acquired the stock. Although, as mentioned above, the Regulations[8] provide that such a contract is to be tested under the facts existing at the time the contract was executed, rather than the time it is questioned, the Tax Court in this instance disregarded the regulations and denied University Chevrolet Co., Inc., about one-half of the deduction claimed for compensation to this stockholder-officer. In so doing, the court very significantly stated "For a sole owner to pay himself a bonus as an incentive to do his best in managing his own business is nonsense." The opinion of the Tax Court was affirmed by the Court of Appeals for the 5th Circuit.[9] It is well to keep this reasoning in mind in any study of methods of compensating executives of closely held corporations who happen also to be controlling stockholders.

The two-and-one-half-month rule

Mention should be briefly made of another statutory requirement affecting compensation paid by a closely held corporation to a controlling stockholder. Section 267(a)(2) of the Code disallows a deduction to an accrual basis corporation for compensation to a controlling stockholder unless such compensation is actually paid during the taxable year or within two and one-half months after the close thereof. This Code provision applies when the employee reports his income on the cash basis and the income accrued by the corporation is not includible in the income of the employee under the doctrine of constructive receipt. While this section is not new, having been contained in the income tax laws ever since enactment of the Revenue Act of 1937, it is one that must not be overlooked when dealing with the closely held corporation, inasmuch as the consequences of its violation are most unfortunate; the employee being required to include the accrued compensation in taxable income when received, actually or constructively, but the employer being denied a deduction therefor at any time.[10] This is another of the problems facing the small closely held corporation with which the larger organization need not be concerned.

Increasingly, employers are finding that to hold their executive personnel, they must design a compensation policy which minimizes the tax take as a method of providing more spendable income to the executive and also furnishing him with side benefits not directly includible as taxable income. It is undoubtedly true that the tax aspects of executive fringes are responsible for much of their popularity, both with the executive and his employer. Generally, benefits are deductible as business expense unless they are in reality a gift to the executive or a dividend to the executive who is also a large stockholder in a closely held corporation. Classification of any benefit as a dividend is, of course, most undesirable. When an executive fringe is so treated, the corporation is denied a deduction although the executive is taxed on its value.

Of late, because of the substantial tax considerations involved, there has been an increasing trend for the employer to pay more and more other expenses of their executives, such as entertainment expenses, club dues and memberships, convention expenses, etc. It is now the policy of the Service to examine the returns of major stockholder-executives in conjunction with the examination of the returns of the corporation. In addition, various policy statements have been published from time to time, explaining the official position on such expenditures.[11] As recently as June of this year, the Service issued a circular on travel and entertainment expenses, mentioning certain areas to which particular attention would be paid by examiners.[12] Specifically mentioned were such matters as the maintenance of branch offices in resort cities and the expense of attendance of executives at sporting events in distant cities under the guise of business expenses.

When an expense payment or reimbursement is questioned by the Service upon examination of the tax returns of a closely held corporation or one of its executives, there is a noticeable lack of uniformity in the recommendations made by the examiners. Normally the agent will: (1) disallow the deduction to the corporation on the grounds that the expense is a personal expense of the executive, or (2) allow the deduction to the corporation but tax the amount to the individual executive as additional compensation, or (3) by far the harshest treatment, forbid any deduction to the corporation, yet tax the amount of expenditure to the executive as dividend income.

Although I do not see a widespread tendency on the part of the Service to disallow deductions to the closely held corporation and include the disallowed amounts representing unsubstantiated expense accounts of the executive-stockholder in the income of the individual, there have been an in-

[6] Blue Ribbon Products Co., Inc., 15 TCM 786.
[7] 16 TC 1452.
[8] See note 2, *supra*.
[9] 199 F.2d 629.
[10] Reg. 118, §39.24(c)-1.
[11] See, e.g., Treasury Department Press Release, February 26, 1952.
[12] IRC No. 57-85, 6/20/57.
[13] B. F. Crabbe, 15 TCM 216; M. L. Cottingham, 15 TCM 987; Marvin T. Blackwell, 15 TCM 962; and Alex and Doris Silverman, 28 TC No. 121.
[14] DC, La., 7/11/56.
[15] GCM 16069, XV-1 CB, p. 84; GCM 8432, IX-2 CB, p. 114.
[16] Reg., §1.403(b)-1(a).

creasing number of cases in which the Tax Court has approved this approach.[13] At the very least, a strenuous argument should be made that the unsubstantiated expenses represent additional compensation to the executive and deductible to the corporation as such. This argument was successful in the 1956 district court case of *W. Horace Williams Company, Inc.*[14] The decision should afford some ammunition with which to combat the double disallowance approach.

There are, of course, many different methods of handling executive expense accounts. Whichever method is employed by the closely held corporation and its stockholder-executives, there is one cardinal rule which cannot be overemphasized. There is no substitute for adequate records to substantiate the deductions claimed. These records should be maintained currently, not reconstructed at year end. The records with respect to executives in control of the payor corporation should be at least as detailed and complete as are required for salesmen and other employees exercising no control over company policies. In the absence of adequate records demonstrating the business nature of the expenses, it can be anticipated that the question will be raised whether such expenses are not in fact personal expenses of the executive.

Group insurance

Insurance programs of various types are of course, another means of providing fringe benefits for the executive. One of the most satisfactory methods of furnishing extensive insurance coverage to executives of closely held corporations, is the adoption by the company of a group insurance program covering executives as well as other employees. Ordinarily, the purchase by a company of an individual policy of insurance for any employee results in taxable compensation to the employee.[15] Similar results attach to the purchase of an annuity for an individual employee, not constituting part of a qualified employees' trust or annuity plan. Where an individual annuity policy is purchased, the employee is taxed immediately upon the premiums paid, provided his interest in the policy is nonforfeitable.[16] If his interest is forfeitable, he will incur no tax as the premiums are paid, but neither will the company secure a tax deduction for such amounts.[17]

In contrast to these individual insurance programs, a group insurance program has the advantage that it is both tax-free to the executive[18] and deductible by the company. In the case of life insurance, the above-stated rule holds true only if the life insurance is term insurance. Premiums paid by the company for ordinary or group permanent insurance, while deductible by the corporation, are held to be taxable to the employee.[19] If the policy combines current and permanent protection with separate premiums for each, only the premiums paid for the permanent insurance are taxable to the executive.

Split-dollar plans

Considerable publicity has been given in recent months to the utilization by corporations of so-called "split-dollar" insurance as a means of compensating executives by providing individual executives insurance coverage at low cost. Most of the interest in this type of insurance stems from the issuance of *Rev. Rul.* 55-713 on December 5, 1955.[20] Corporations often find it necessary or desirable to assist an executive with his insurance program as an individual and not as a part of a group. The drawback has been that regardless of the type of insurance coverage, premiums paid by the corporation have been considered to be taxable to the executive. A split-dollar insurance plan similar to the one approved in *Rev. Rul.* 55-713 provides a workable alternative. In the plan approved by this ruling, the policy was applied for and owned by the employer. A supplementary agreement was entered into between the employer and the employee, to which the insurance company was not a party. In this supplementary agreement, the employer agreed to pay each year an amount of premium equal to the increase in cash value of the policy and the employee agreed to pay the balance of the premium. Any dividends earned on the policy were to be used to reduce premiums and upon the death of the employee the death benefit was to be divided by paying an amount equal to the cash value of the policy to the employer with the balance being paid to the beneficiaries designated by the employee. The ruling held that the employer's premium payments were not taxable to the employee and that the division of the death benefits produced no taxable income to the employer or the designated beneficiary of the employee. The Service considered that the substance of the arrangement was the same as if the corporation had made an interest-free loan to the executive, permitting him to extend his insurance coverage. The corporation merely pays out premiums which it will eventually recover, dollar for dollar. It is fully protected for the amount of its advance by the insurance policy. Of course, it gets no deduction for the premium payments. By the same token it is not required to pay income tax on the return of its advance from the proceeds of the policy upon the death of the employee.

The closely held corporation is confronted by a special problem if it is desired to utilize split-dollar insurance to compensate an executive who is the principal or sole shareholder of the corporation. The danger here is the possibility that the Service might attempt to apply the theory involved in a line of cases of which *Paramount-Richards Theatres, Inc.*,[21] is representative, and contend that the premium payments by the corporation were taxable as a dividend to such a stockholder since the policy was carried more for the benefit of the executive than the corporation. Actually, in a letter ruling issued subsequent to *Rev. Rul.* 55-713, the Service stated that the facts upon which the ruling contained in *Rev. Rul.* 55-713 was based did not contemplate either the employee involved being a majority stockholder of the employer corporation or any close relationship between the employee and the majority stockholders of the corporate employer.[22] This evidence of attitude by the Service with respect to the application of *Rev. Rul.* 55-713 would seem to counsel caution in the use of split-dollar insurance by a closely held corporation for the benefit of a stockholder-employee.

Other insurance

In addition to life insurance plans, executive fringe benefits often include other types of insurance programs such as group disability and group health and accident plans. Increasingly common, also, are hospital and medical benefits under plans similar to Blue Cross, Blue Shield, and others. Such plans can pro-

[13] Reg., §1.404(a)-12.
[14] Proposed Reg., §1.61-2(d)(2).
[15] Mim. 6477, 1950-1 CB, p. 16.
[16] 1955-2 CB, p. 23.
[17] 153 F.2d 602 (CA-5, 1946). See also the more recently decided cases holding insurance premiums paid by a closely held corporation to be taxable income to stockholders who would benefit therefrom. Oreste Casale, 26 TC No. 131, Revised (CA-2, 9/5/57), 57-2 USTC, Par. 9920; Henry E. and Winifred L. Prunier, 28 TC No. 4; and Sanders, 149 F. Supp. 942.
[18] *Split Dollar Insurance*, Harry S. Redeker, Proceedings N.Y.U. 15th ANN. INST. on FED. TAX.
[19] Int. Rev. Code, Sec. 105.

vide benefits not only for the executive but for his entire family. The 1954 Code[23] specifically provides that amounts paid or reimbursed for medical care of the employee and his family shall be tax-free. The same treatment is accorded to amounts paid to compensate for the loss of a bodily member or function, or for disfigurement of the employee or his dependents and amounts paid for "sick pay" up to a maximum of $100 per week. The attractiveness of these Code provisions to the closely held corporation lies in the fact that the benefits can be provided for only one or two selected executives if the company so desires.

Death benefits

Another common executive fringe benefit being provided by more and more corporations, both closely held and publicly owned, is the payment of $5,000 nontaxable death benefits to the beneficiaries or the estate of executives or other key employees.[24] Under the 1954 Code there is no longer a statutory requirement that the death benefits be made pursuant to a contract. There would appear to be no problem with respect to the deductibility of such payments by the corporate employer where the amounts are paid in recognition of past services and are reasonable in amount. The Commissioner's Regulations providing for the deduction of amounts paid to the widow or heirs of an officer or an employee by a continuation of the officer's salary for a limited period after his death in recognition of services rendered by the individual, would seem to be sufficiently broad to cover the deduction of this expenditure by the corporation in nearly every instance.[25]

The interesting tax aspects of this executive fringe benefit will no doubt, as in the past, continue to be associated with the deductibility and includibility of payments in excess of $5,000. In cases arising under the 1939 Code, the courts have been quite consistent in finding that all voluntary payments made to a widow in recognition of services performed by the deceased employee, constituted gifts to the widow which were nontaxable for income tax purposes.[26] An interesting point which does not seem to have developed in these cases dealing with the taxability of the payments to the widow, was whether such payments, if they are gifts to the widow, can constitute tax deductions to the corporation. A gift is not ordinarily deductible for income tax purposes and if the payment is a gift to the recipient, it would seem also to be a gift when made by the payor. To date, the Commissioner does not seem to have simultaneously attacked both the payment of the item by the corporation and its receipt by the widow. Instead, the issue always involves the taxability of such payments to the widow and the Commissioner relies on a ruling issued in 1950.[27] This ruling rescinded a previous ruling holding such payments to be nontaxable[28] and announced that the Service would consider all such payments made subsequent to January 1, 1951, to be taxable income to the recipient.[29] Despite the abrupt change in position by the Service relative to the taxability of such payments, the Tax Court does not seem to have been impressed, and continues to determine their tax status much as it did prior to the issuance of the ruling.[30] Both prior to and since the enactment of the 1954 Code, payments made pursuant to a contractual liability in excess of the $5,000 statutory exclusion, have probably constituted taxable income to the recipient, since it would be difficult to classify a contractual payment as a gift in the hands of the recipient.[31]

Free medical examinations

Another fringe benefit which is finding increasing popularity is the practice of furnishing periodic free medical examinations to executives. Such examinations qualify as tax-exempt medical care for the executive[32] which is fully deductible by the company. The furnishing of such examinations is valuable to the executive by providing him with reassurance as to the condition of his health at no cost to him. In addition, it protects the company against the sudden and unexepected loss of a key executive for whom no replacement is available.

Vacations and holidays

Such practices as arranging a business conference in Florida for one day sometime during the height of the winter season, then remaining in Florida for three or four weeks before returning to work up north, with all of the costs incurred during the entire absence being charged as business expense incurred in connection with the one-day conference, are representative of the type of practice which the Service finds objectionable. This does not mean that an executive cannot combine a business trip with a simultaneous vacation in the same area, provided no more than the expenses legitimately incurred on the business trip are charged as business expense. Here again the possibility of dividend status for such excess expenses must not be overlooked when the executive is also a stockholder.

Automobiles, airplanes, etc.

Usually so long as the personal use of such equipment is no more than negligible, no question will be raised as to deductibility of depreciation plus yearly operating costs thereof as a business expense. Where the use of such equipment for commuting and other personal reasons is more than negligible, the usual practice is to allow the company a deduction but to tax the depreciation and costs allocable to personal use as additional compensation to the executive. In one case, [33] the Tax Court held ". . . the equivalent of 10% of the cost of operating the automobile and 10% of the depreciation for 1941 was properly included in his income as additional compensation from Brass Rail, being the approximate value of his personal use of the car." The Service is inclined to be considerably harsher than the Tax Court, and normally insists on a greater allocation to personal use than 10%. This is especially true in situations where the examiner finds that the individual executive has not owned any personal car whatsoever for the use of himself and his family, or where the records indicate that more than one company-owned automobile is furnished to the executive for his use, both business and personal.

Pension and profit-sharing plans

So far in our discussion of methods of compensating executives of the closely held corporation, we have concerned ourselves with methods of providing current compensation. An increase in current compensation is not particularly attractive to an executive who must pay

[24] Int. Rev. Code, Sec. 101(b).
[25] Reg. 118, §39.23(a)(9).
[26] Slater v. Riddell, 56-2 USTC, §9892; Ruth Hahn, 13 TCM 308; Marie G. Haskell, 14 TCM 788. Arthur W. Hellstrom Estate, 24 TC 916; John Hekman Estate, 16 TCM 304; and Ethel Gregg Mann, 16 TCM 212.
[27] IT 4027, 1950-2 CB, p. 9.
[28] IT 3329, 1939-2 CB, p. 153.
[29] Note 27, *supra*.
[30] Note 26, *supra*.
[31] Flarsheim, 156 F.2d 105 (CA-8, 1946); Arthur W. Davis Estate, 11 TCM 814.
[32] Int. Rev. Code, Sec. 105(b).
[33] Rodgers Dairy Co., 14 TC 66.
[34] Int. Rev. Code, Sec. 401(a).
[35] Int. Rev. Code, Sec. 401(a)(4).
[36] Reg., §1.401-4.
[37] Int. Rev. Code, Sec. 404; Reg., §1.404(a)-1(b).

50 to 90% thereof to the Government in taxes. The executive of the closely held corporation, whether stockholder or nonstockholder, is, however, vitally interested in any plan which will defer a portion of his current earnings to a subsequent period when he anticipates being in a lower tax bracket. Even better is a plan which will convert ordinary income into capital gain.

The Code attempts to provide the solution to the search for adequate deferred compensation plans for employees by providing for the now well-known qualified pension and profit-sharing plans. The requirements for qualified plans are furnished in the applicable Code section.[34] Both the qualified pension plan and the qualified profit-sharing plan receive favorable tax treatment with benefits extending to the employer as well as the employee. In addition, if a trust is utilized in establishing the qualified plan, there are tax advantages to the trust.

Troublesome provision

The Code provision most likely to cause trouble to the closely held corporation desiring to utilize a qualified pension or profit-sharing plan to augment executive compensation is the requirement that the plan must benefit employees in general. A plan will not be approved by the Service which discriminates in favor of officers, shareholders, or supervisory or highly compensated employees.[35] The requirement of nondiscrimination applies both in determining the employees covered by the plan and in allocating the contributions or benefits provided by the plan.[36] In considering the desirability of a qualified plan as a means of providing additional compensation for executive personnel, it is important to bear in mind the fact that there will be no discrimination if contributions to the plan by the employer are allocated to employees in proportion to their regular salaries from the employer, even though such an allocation will necessarily result in highly paid employees receiving a larger share of the benefits. Within the statutory framework, the qualified plan can operate to provide worthwhile compensation increases to executive personnel of the closely held corporation.

The importance of qualification can be demonstrated by a consideration of the tax benefits to be obtained. Under a qualified plan, the employer is allowed to deduct contributions to the plan currently,[37] while employees covered by the plan, including executives and stockholder-employees, incur no tax liability until they receive a distribution.[38] If the employee receives all of his accumulated benefits under the plan in any one year on account of death or other termination of employment, the distribution can be reported as capital gain rather than ordinary income.[39] Any income earned by the trust established under a qualified plan is exempt in the hands of the trustee.[40] Other tax advantages include the benefit of the $5,000 exclusion from gross income from amounts paid to beneficiaries of the estate of a deceased employee by reason of the employee's death;[41] the provision that if the trust invests its funds in stock of the employer corporation, which stock is distributed to the employee upon retirement, the income to the employee will be measured by the cost of the stock to the trustee and will not include appreciation in value during the period of ownership by the trustee;[42] and the provision for exclusion from the gross estate of the employee for estate tax purposes, of amounts payable under the plan to the employee's beneficiary upon the death of the employee.[43]

Deferred compensation plans

Despite the attractive tax possibilities mentioned above, as a means of providing deferred compensation for executives of a closely held corporation, the qualified pension or profit-sharing plan has the very obvious limitation that it must be made applicable to a comparatively large group of employees and cannot be pinpointed for specific individuals. This situation has led to the present-day popularity of the so-called nonqualified deferred compensation plan. Basically, the deferred compensation plan involves an agreement between an employer and a specific employee whereby the employer promises to pay additional compensation to the employee in future years as part of the consideration for services currently rendered. The agreement will recite that in consideration of the employee's continuing as an employee for a stated period or until reaching retirement age, the employer will thereafter pay him a specified amount for life or a stated number of years. Payments to an employee under a successful deferred compensation plan are deductible by the employer and taxable to the employee in the year in which paid. If the agreement requires the employer to continue payments to the widow upon the death of the employee before receiving all the payments provided therein, such payments will be taxable to the widow the same as they would have been to the employee.

The primary objective of the deferred compensation contract is the postponement of the receipt of taxable income by the employee until after his retirement when he expects to be in a lower tax bracket. The test of the successful agreement is whether it succeeds in this objective. Ordinarily, the executive of the closely held corporation will report his income on a cash basis. This means that he pays tax thereon when the money is received. In order to be successful in imposing tax against a beneficiary of a deferred compensation contract prior to such time, taxability would have to be asserted under either the theory of constructive receipt or the so-called economic benefit theory. The constructive receipt doctrine holds that income made available to a cash basis taxpayer is subject to tax even though he elects to postpone actual receipt. Under the economic benefit theory, the contention is made that an individual has realized taxable income in some form other than cash. If this latter theory were applicable, it would be found that the employer's promise to pay the employee a fixed sum in the future resulted in the incurrence of tax at the time the services were rendered.

The leading cases involving taxability of this type of contract under the doctrine of constructive receipt hold that tax liability will be found to exist only where the deferment of income occurs after the right to receive it has matured. It is reasonably well established that arm's length agreements entered into before the income is earned will result in avoiding the application of the doctrine of constructive receipt.[44] In order to avoid tax under the economic benefit theory, it is necessary to establish that

[34] Int. Rev. Code, Sec. 402 and 403; Reg. §1.402 (a)-1(a)(1)(i).
[35] Int. Rev. Code, Sec. 402(a)(2) and 403(a)(2); Reg., §1.402(a)-1(a)(6)(i) and 1.403(a)-2(a).
[36] Int. Rev. Code, Sec. 501(a); Proposed Reg., §1.501(a)-1(a).
[37] Int. Rev. Code, Sec. 101(b)(2)(B).
[38] Int. Rev. Code, Sec. 402(a)(2). Reg., §1.402 (a)-1(b).
[39] Int. Rev. Code, Sec. 2039(c).
[40] Oates, 207 F.2d 711 (CA-7, 1953); Wilfred Weathers, 12 TCM 314.
[41] Frederick John Wolfe, 8 TC 689. [See also Cyde v. Beckner, TC Docket 62095, in which the Commissioner is asserting that the entire amount of deferred compensation was income in the year the contract was signed. However, this contract was used by the taxpayer as collateral for a loan. —Ed.]

the promise of the employer to make a future payment is not the receipt by the employee of something of value to which tax attaches. The employee has a strong argument if the contract provides that he will receive nothing in the event he terminates his employment before reaching retirement. Even if the forfeitability argument is not possible under the contract, ordinarily the employee has only the unsecured promise of the employer to make the future payments. This is quite different from the promise of an insurance company to pay an annuity for which it is required to set aside reserves, or from a situation in which the employee has a nonforfeitable interest in an established fund set aside by the employer.

It is advisable, in drafting a deferred compensation agreement, to incorporate therein conditions which make the rights of the employee clearly forfeitable in the event he fails to live up to any of the commitments to which he obligates himself. In addition to an agreement to continue to remain in the employ of the employer for an agreed period of time or until reaching a certain age, it is well to have the employee agree to hold himself available as a consultant after retirement and not to compete or enter the employ of a competitor. Assurance of the desired tax status for such contracts can also be increased by inclusion of a provision to the effect that the employee will suffer a reduction in the amount of his deferred payment in the event he earns more than a certain designated amount during the period when the deferred compensation is payable.

Finally, I find it helpful to include a provision in deferred compensation contracts to the effect that the contract is not assignable by the executive concerned. The courts have seemed to imply that if an executive is unable to realize upon the contract immediately, by selling it or borrowing upon it, then he has not received any immediate economic benefit which should be subjected to tax.[45]

To further emphasize the distinction between the qualified pension or profit-sharing plan and the unqualified deferred compensation plan, the impracticability of funding the latter should be mentioned. In the event a fund is established in which the employee has a nonforfeitable interest, the amount paid into the plan by the employer becomes immediately taxable to the employee,[46] thus defeating the entire purpose of the plan. On the other hand, if the interest of the employee is forfeitable, he will not be deemed to have received taxable income until such time as distributions are made from the fund to him,[47] but at the same time the employer will receive no tax deduction, either at the time the fund is established or at the time the payments are made to the employee.[48]

Impact of Casale decision

In lieu of the establishment of a separate fund to provide assurance that the corporation will fulfill its obligation under the plan, many companies naturally turned to insurance programs to protect the executive's rights. In a decision involving the use of insurance in such a situation, which has long been awaited in tax circles, the Court of Appeals for the Second Circuit reversed the decision of the Tax Court in the case of *Oreste Casale*,[49] and found for the taxpayer in a very important case involving this issue. In this case a corporation entered into a deferred compensation agreement with its majority stockholder and then purchased a combined life and annuity contract, insuring the life of the stockholder in order to fund the deferred compensation agreement. The corporation was the owner and beneficiary of the policy and the benefits under the policy were identical with those provided by the deferred compensation agreement. In the agreement, the stockholder-employee was given the right to designate who would be beneficiary in the event of his death. The compensation agreement contained the stock provisions with respect to forfeitability; namely, that his rights would be forfeitable if he left the company's employ without consent prior to his retirement, or if he entered into competition with the corporation after his retirement. Inasmuch as Casale owned 98% of the stock, the Tax Court felt that such provisions were meaningless and that in effect his rights under the retirement agreement were nonforfeitable since the petitioner had failed to maintain an arm's length relationship in dealing with his corporation. It held that the annual premium paid on the policy represented a distribution to Casale equivalent to a taxable dividend. The Second Circuit reversed, holding that there was no taxable distribution to Casale by reason of the payment of premiums on the insurance policy. It was emphasized in the opinion that the policy was a corporate asset subject to prior claims of corporate creditors in case of insolvency. The court could find no basis for disregarding the corporate entity and pointed out that the corporation could satisfy its obligations under the deferred compensation agreement by funds from any source. It was possible for the corporation to realize more from the policy than the amount of its obligation to Casale.

The Tax Court decision in the *Casale* case had been criticized in tax circles for many of the reasons cited by the Court of Appeals in reversing.[50] Undoubtedly, the Service has received a setback in its attacks on this type of contract entered into between corporations and controlling stockholders. It would seem to be established that such an agreement is not, per se, impossible to sustain in this situation. [See also reversal of *Prunier*, p. 12—*Ed.*]

Stock options

No discussion of methods for compensating executives of the closely held corporation would be complete without at least a mention of the present tax status of stock option plans. The decision of the Supreme Court in 1956 in *LoBue*[51] has probably sounded the death knell to the formerly popular unrestricted option. This will undoubtedly lead to increased use of the "restricted" stock option provided by Section 421 of the Code. The statute spells out the requirements for this type of stock option. These requirements are rather complex and must be strictly complied with if the desired tax consequences are to result.

Special statutory provisions of particular interest in the case of closely held corporations, require that if the employee owns more than 10% of the voting stock of the corporation, the option price must be at least 110% of the fair market value of the stock at the time the option is granted. In addition, the option cannot run for longer than five years, as compared to the ten-year period allowed where the optionee owns less than 10% of the stock.

There can be no doubt that the requirement that the option price be at

[46] Int. Rev. Code, Sec. 402(b); Reg., §1.402(b)-1(a).
[47] Reg., §1.402(b)-1(a).
[48] Int. Rev. Code, Sec. 404(a)(5); Reg., §1.404(a)-12.
[49] 26 TC No. 131.
[50] See, e.g., Lawthers "*Weakness in Casale Decision*," 5 JTAX 342.
[51] 351 U.S. 243.

least 110% of the fair market value where the individual owns 10% of the stock of the corporation, is a deterrent in the use of this type of option by the closely held corporation. For non-stockholder-executives, the statute recognizes options where the option price is at least 85% of the fair market value of the stock when the option is granted. Another deterrent is the difficulty of determining the fair market value of stock which is not listed on an exchange and in which there is no active trading. Until some practical solution to these problems is developed, the closely held corporation will be hesitant to adopt this form of providing compensation for its executives.

In conclusion, it should not be necessary to point out that the problems dealt with are only a very few of those encountered in the field of executive compensation by closely held corporations. Methods for successfully increasing "real" compensation to this group at minimum tax cost are constantly being evolved and tried out. There is no reason to anticipate any reduction of activity in tax cases involving the problem here considered, in the future. ☆

New compensation decisions this month

Payments for contract termination compensation not capital gain. In 1944 taxpayer entered into a contract with a corporation to manage its petroleum division which held a franchise from Sun Oil Co. Taxpayer was to receive a salary and a percentage of profits, but the profit percentage was to be used to acquire preferred stock of the corporation. Because the corporation was reluctant to exert the effort necessary to exploit the franchise properly, the parties agreed in 1945 to cancel the contract. Taxpayer received $15,000 over several years pursuant to this cancellation agreement. The court finds the contract was one of employment and not a joint venture between him and the corporation. Accordingly, the termination payments were ordinary income rather than capital gain. *Copeland,* DC N. Y., 7/23/57.

Tax Court must hear evidence on value of option stock subject to resale restrictions. This case is developing a history. Taxpayer, an executive of Household Finance Corp., received an option to purchase stock of that company subject to an agreement not to sell the stock as long as he was employed there. In a prior proceeding, this court reversed the Tax Court's determination that taxpayer realized income measured by the market value of the stock on the New York Stock Exchange. It remanded the case for a determination of the value with the resale restriction. The Commissioner then attempted on remand to introduce evidence of a formula to determine this value, but the Tax Court refused the evidence and found there was no deficiency, observing somewhat petulantly that there was no possible formula. Now this court again remands to the Tax Court for a hearing of the evidence and a finding of fact on the issue of value. *MacDonald,* CA-7, 10/21/57.

Pension contribution, paid within 60 days of year end, not deductible; no liability at year end. Taxpayer's fiscal year ended September 30; on September 21, the Board of Directors authorized a pension plan and approved an agreement with the trustee. On November 27 it paid the trustee the initial premium of some $21,000. The plan was adopted December 1, 62 days after the close of the year. The court holds that taxpayer failed to show that it incurred any liability for the contribution before the close of that year. The evidence showed that during the taxable year no pension trust committee had been set up, no rules were formulated as to employee eligibility, and no computations as to the required first-year contributions had been made. *Barrett Timber & Dunnage Corp.,* 29 TC No. 11.

IRS won't deny pension plan to association of professionals taxable as corporation. The IRS announces that it has reconsidered the position it took following the *Kintner* case (216 F.2d 418). There the 9th Circuit held that a group of doctors could establish a pension plan for the doctor members as corporate employees. The Commissioner announced (*Rev. Rul.* 56-23) that he would not follow the case and would not regard such an association of professionals as a corporation for the purpose of permitting it to establish a qualified pension plan if the purpose for forming the association was to obtain this tax benefit. Now the Commissioner announces that the fact that the association establishes a pension plan is not determinative of whether it will be classified as a partnership or an association taxable as a corporation. Basic criteria for this determination will be set forth in a ruling to be published later, the IRS adds. *TIR* No. 61.

Employer's contribution of its stock held in escrow will not disqualify employees' plan. The Service requires unrestricted marketability with respect to stock or securities of the employer corporation contributed to an exempt employees' trust. It now holds that an employees' stock bonus plan will not fail to qualify simply because the stock of the employer, which comprises the trust assets, must under applicable state law be held in escrow by state authorities. The state securities law provides that the commissioner of corporations must hold in escrow the stock of newly organized corporations and the purchaser must sign a statement that he is familiar with the stock. Generally, in the absence of fraud or bankruptcy, transfers of the stock are approved. *Rev. Rul.* 57-372.

Exclusion for two weeks sick pay for employee on semimonthly pay period computed on daily base. Taxpayer is paid semi-monthly; he works eight consecutive days and is off six in a two-week period. He received wage continuation benefits for each of his normal work days for a two-week period during which time he was absent from work because of an injury. Since taxpayer received payment for less than a half full pay period (one-half month here), the Service holds the sick-pay exclusion is to be computed in accordance with the daily exclusion rule set out in the Regulations. *Rev. Rul.* 57-399.

Retroactive pension plan with current funding fails to qualify. In accordance with the terms of the plan, death benefit payments are to be made to dependents of an employee who died prior to the adoption of an employees' pension plan. However, the actuarial computation regarding contributions included only those employees actually employed on the date of establishment of the plan. The Service rules that the deceased employee cannot be considered a participant and any payments to his estate will disqualify the plan. *Rev. Rul.* 57-513.

NEW DEVELOPMENTS IN

Foreign aspects of taxation

EDITED BY SIDNEY I. ROBERTS, LL.B., CPA, JOHN COSTELLOE, LL.B., AND JOHN WILCOX, LL.B.

U. S. taxpayers who fail to claim treaty dividend rates may forfeit credit

A RECENT ruling of the IRS will be found to be of particular interest to taxpayers receiving dividends (or other forms of income) with respect to which foreign tax has been withheld at the source. In *Revenue Ruling* 57-516, IRB 1957-44, 22, the Service ruled that the amount of tax withheld will be allowable as a credit only to the extent that such amounts constitute "a legal and actual liability, paid or accrued during the taxable year by or in behalf of the taxpayer claiming such credit." The tax withheld is referred to as merely an advance collection of what may not be an actual tax liability.

The exact intended scope of the ruling is not clear on the surface. However, it seems certain that one of the principal targets is the withholding tax under income tax treaties. Under a substantial number of our income tax treaties with foreign countries, dividends are either subject to a reduced rate of taxation, or eligible for exemption from taxation.

In cases where the usual foreign rates are below the U. S. tax rate applicable to income received from such foreign country, the treaty rate may offer no advantage to the U. S. taxpayer since, if he is eligible for the foreign tax credit (i.e., he itemizes deductions), he will receive a full credit for the foreign taxes withheld.

In the usual case, taxpayers eligible for reduced rate of tax or exemption under a treaty must file with the foreign withholding agent or the foreign government some proof of entitlement. In many cases where the taxpayer considers that he would receive a full foreign tax credit in the United States for foreign taxes withheld, he has found it, perhaps, too much of a bother to claim the treaty benefits and has allowed the full foreign tax to be withheld.

The Service has now warned these taxpayers that this practice will no longer be countenanced. Thus, taxpayers receiving dividends or other income with respect to which foreign taxes are withheld will be required to claim any treaty benefits or tax benefits unilaterally granted by a foreign taxing jurisdiction to which they may be entitled or forfeit the foreign tax credit to that extent.

Of course, the wording of the ruling is quite broad and would apply to all foreign withholding. In other words, the ruling purports to impose upon taxpayers receiving income from which foreign tax has been withheld a duty to ascertain that they are actually liable for that tax, and that the withholding agent did not act in error. However, as a practical matter, it is not likely that foreign withholding agents would effect any tax withholding in the absence of a local law requirement, and it is further unlikely that the U. S. Government would embark upon a course of inquiry into the foreign law in every routine case of withholding. Accordingly, it seems that the ruling is directed primarily at the obvious situation such as treaties where it may be clear under certain circumstances that the tax withheld was in excess of the taxpayer's legal liability to the foreign government, and perhaps also the less frequent situation where the taxpayer may be entitled to claim a tax benefit unilaterally granted by a foreign country.

Harvard releases three volumes in World Tax Series

OF VITAL importance to those involved in transactions abroad is the publication of the first three volumes of the World Tax Series.* Covering the tax systems of the United Kingdom, Brazil, and Mexico, the volumes amply measure up to the promise that was widely felt at the start of the program.

The World Tax Series program was initiated, in consultation with the United Nations Secretariat, by the International Program in Taxation at the Harvard Law School, under Professor Stanley S. Surrey, director of the International Program, and Dean William S. Barnes, Director of the World Tax Series. The purpose of the series is to present information on national tax systems throughout the world. The three volumes issued demonstrate that the series will furnish an invaluable tool to persons interested in the taxation of foreign enterprises.

First, these volumes will be indispensible to the tax advisor whose client or employer, a foreigner in the particular country, has a business or investment contact with that country; for example, the U. S. tax advisor with a client about to invest in the United Kingdom. Confronted with a situation of this type, it seems eminently desirable to obtain the services of a qualified tax advisor within the United Kingdom. The United Kingdom volume in the World Tax Series is hardly intended to permit dispensing with his services. However, the converse is also true: reliance on the United Kingdom tax advisor does not dispense with the need for the book.

The most important function of the book for the U. S. tax advisor is to assist him in communicating with his U. K. counterpart. While more obviously true in the case of non-English-speaking countries, the necessity for facilitating the exchange of information does exist, even in the United Kingdom. (Compare the difficulty sometimes encountered by U. S. tax advisors in explaining tax provisions to the non-specialized accounting and legal brethren.) This function may range from (a) merely assisting the U. S. adviser to comprehend the foreign tax advice and transmit the conclusion to the client, to (b) permitting

* Taxation in the United Kingdom: *Editor:* Walter W. Brudno, A.B., LL.B., Research Associate in Law, Harvard University. *Correspondent:* Frank Bower, Tax Manager, Unilever Limited, London; Chairman, Taxation Committee, British Federation of Industries. $15.00.

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All three books are published for Harvard by Little, Brown & Company, Boston.

the U. S. adviser to suggest possibilities which may not occur to the foreign tax counsel, perhaps because he is not sufficiently indoctrinated in the affairs of the client to appreciate all the alternatives.

The more academic function of permitting a comparative study of tax laws is no less important. Governments considering tax reforms or engaging in negotiation of international tax agreements, as well as students of the theory of taxation, will find these invaluable tools. This function is considerably aided by uniform paragraph numbering and cross reference systems for each study.

Much may be learned even by the legislators and administrators by a study of foreign concepts and practices. For example, our own legislators may consider the comment (Taxation in the United Kingdom, p. 1/2.2) that taxes are never levied retroactively in the United Kingdom, even where legislation is enacted to prevent circumvention of earlier legislation, unless advance warning has been given by the Chancellor of the Exchequer; or (*Ibid.*, p. 1/3.5b) that there is no jury trial in tax cases except in the case of fraud.

A quick picture of Australian taxes; No. 2 in new series

PRACTITIONERS who want to know something about the tax situation in a foreign country without wading through foreign-language publications will be interested in a new series of pamphlets "Taxes Abroad," being put out by the Canadian Tax Foundation. The second number has just appeared, dated July, 1957, devoted to the tax picture in Australia. It explains the Australian income tax law, which covers taxation of individuals and companies and the tax on undistributed income of private companies; and also the Australian International Tax Agreements.

Tax men desiring copies of this excellent pamphlet may obtain them on request to the foundation, at 154 University Ave., Toronto 1, Canada. ☆

New foreign decisions this month

IRS can examine records despite claim of residence abroad [*Certiorari denied*]. An international lawyer, taxpayer practiced in foreign countries. He was subpoenaed by the Service, but he declined to answer some questions. He argued that he was a bona fide resident of a foreign country in the years under review and was therefore exempt from U. S. tax on earnings, that questions concerning income were irrelevant if he was not required to file a return, and that the only inquiry presently proper is into his foreign residence. The district court upheld the Service and the Second Circuit affirmed. The court will not try to determine the extent of inquiry; to do so might disable the administrative authority. Moreover, the extent of his income and activities abroad might be relevant to the question of residence. *Carroll, cert. den.* 10/21/57.

Foreign corporation fails to qualify as a resident. Taxpayer held part of the holdings of Axel Wenner-Gren. It assumed some of his liabilities to U. S. bank and held his stock in Servel and Electrolux which it pledged as security. It claimed the tax status of a resident foreign corporation in order to receive tax benefits under 1939 Code Section 231. [Under both the 1939 and 1954 Codes a foreign corporation engaged in business in the U. S. pays the regular rates on income from U. S. sources and is allowed deductions; one not so engaged pays 30% on fixed and determinable income from U. S. sources and is allowed no deductions.—*Ed.*] The court finds that taxpayer here was not "engaged in business" in the U. S. and did not qualify. There was neither consistency nor frequency in those few isolated activities which could even be considered as "business." *Continental Trading Inc.*, TCM 1957-164.

Canadian corporation not liable for U. S. tax, failure to file reasonable. [*Acquiescence*]. Cyrus Eaton and William Daley, both employees of Otis & Co., the U. S. investment banking firm, were the spark plugs in the development of the Canadian mine Steep Rock. Their financial interest was their ownership of taxpayer here, created to act as sales agent for Steep Rock. Taxpayer had a mailing address in Ohio but no assets, books, officers, directors, employees, or other agents authorized to do business for it in the U. S. The court held taxpayer did not engage in trade or business nor did it create a "permanent establishment" here. Accordingly, pursuant to the Canadian tax treaty, it is immune from U. S. tax on industrial or commercial profits. It was taxable on a small amount of interest not exempted by treaty. Additions to this tax for failure to file were improper. Taxpayer had reasonable cause for failure to file in the advice of experienced lawyers. *Consolidated Premium Iron Ores, Ltd.*, 28 TC No. 19, *acq.* IRB 1957-38.

Must withhold on market value, not basis, of property dividend to foreign corporation. A taxable dividend in stock of another corporation is being distributed by a domestic corporation to a foreign corporation. The IRS rules that tax withholding at source must be computed at the proper per cent of the full market value of the distribution, rather than on the lesser adjusted basis in the hands of the distributing corporation. The IRS notes that the Code rule providing the basis of a property dividend in the hands of a corporate stockholder is the basis to the paying company, is inapplicable. That rule does not apply to a nonresident foreign corporation. *Rev. Rul.* 57-470.

Certain nontaxable interest excluded in applying test for W.H.T.C. In determining whether the gross income of a domestic corporation is, in the proper percentage, from sources outside the Western Hemisphere, the IRS rules that interest on certain U. S. and state obligations which are exempt from tax are excluded from gross income. *Rev. Rul.* 57-435.

Specific German indemnification laws identified. The Service clarifies *Rev. Rul.* 56-518 holding certain indemnification payments to former German citizens nontaxable by identifying the specific laws of the Federal Republic of Germany which constitute the basis for the ruling. *Rev. Rul.* 57-505.

Foreign tax credit allowed only for actual tax liability. Income tax withheld at source from foreign dividends may be taken as a foreign tax credit only if the amount withheld represents a legal and actual tax liability. Credit will therefore not be allowed for any part of the amount withheld to which taxpayer is entitled. [See comment on page 44.—*Ed.*] *Rev. Rul.* 57-516.

NEW DEVELOPMENTS IN TAX ASPECTS OF

Accounting

EDITED BY CARL M. ESENOFF, CPA, & C. W. LAMDEN, Ph.D., CPA

When can a successor corporation use a predecessor's loss?

by **DOUGLAS H. ELDRIDGE**

One of the most obscure areas in the whole Code is that dealing with the use of net operating loss carryovers in corporate acquisitions. The sections themselves are difficult to apply; an almost impenetrable uncertainty arises wherever the Code is not completely explicit. Mr. Eldridge (whose views, of course, are his own and not to be attributed to the Treasury), traces the development of the present rules, with exhaustive reference to legislative history to show the purpose of each change. We have adapted the section which deals with the rules laid down in the 1954 Code and the six somewhat inconsistent criteria it uses to determine the transferability of losses.*

THE 1954 legislation governing the transferability of loss carryovers was enacted in recognition of the need for more definite statutory rules. The new Code provides for the carryover of a number of tax benefits, including the net operating loss deduction, from one corporation to another in certain tax-free liquidations and reorganizations. It was intended that the successor corporation would be enabled to step into the "tax shoes" of its predecessor in accordance with the economic realties of combining separate businesses into a unified enterprise, rather than to have the tax consequences depend upon such artificialities as legal form. At the same time, limitations were imposed which were designed to prevent the tax abuses.

Section 381 of the 1954 Code specifically provides for the carry-forward of net operating losses from a predecessor to a successor corporation where the assets of one are acquired by the other in a tax-free liquidation of a subsidiary or in a tax-free reorganization. The section does not provide for carryover of losses in divisive reorganizations such as splitups and spinoffs. An exception is also made for nontaxable liquidations in which the basis of the assets distributed is determined by the basis of the stock with respect to which the distribution was made, in accordance with Section 334(b)(2), which follows the *Kimbell-Diamond Milling Co.* rule (14 TC 74 (1950), *aff'd* 187 F.2d 718 (5th Cir. 1951). Moreover, a successor corporation may not carry back its losses to a prior taxable year of the distributor or transferor corporation, except where a reorganization involves a mere change in identity, form, or place of organization. But in general, Section 381 clarified the former law by providing that loss carryforwards pass to successor corporations, rather than having the loss deduction disappear along with the predecessor corporation if a reorganization took certain forms.

Section 382 places restrictions on the use of loss carryovers by successor corporations. Subsection 382(b) relates to the loss carryovers allowed in tax-free reorganizations by Section 381 and follows the principle that the carryover is to be allowed in full only if the shareholders of the predecessor loss corporation have a substantial continuing interest in the successor. Unless the shareholders of the former loss corporation own 20% of the stock of the successor after the reorganization, the use of the loss carryover by the latter corporation will be disallowed proportionately. In effect, the loss carryover is reduced by 5% for each percentage point below the requisite 20% interest in the acquiring corporation held by the shareholder of the former loss corporation.

This limitation operates uniformly regardless of which entity may be said formally to survive the reorganization. Whether the former loss corporation, the former profitable corporation, or a new entity is the acquiring corporation which emerges, the availability of the loss carryover depends upon the degrees of continuing ownership by the former loss-corporation shareholders. The rule is tighter than prior law in the sense that formerly a full carryover might be allowed if the loss corporation was deemed to be the surviving entity regardless of its ownership.

Subsection 382(a) of the 1954 Code denies a corporation the carryover of net operating losses from prior years where the ten largest shareholders of the corporation as of the end of the year have increased by 50 or more percentage points their ownership of the market value of the stock within a two-year period and the corporation does not continue to carry on substantially the same trade or business as before the change in ownership. This provision was intended to curb the most common abuses where corporations with a history of losses were acquired to offset profits in unrelated types of business. Thus a loss carryover of the same continuing corporate entity may be denied if half of its stock is acquired within two years by a few persons and the character of the business is changed.

Sections 381 and 382 appear to preclude the extreme cases in which corporate shells might be purchased to offset their past losses against another company's profits. A corporation whose only value lies in its claim of tax losses can scarcely be said to be conducting a trade or business prior to sale or to be continuing one thereafter. Moreover, since Section 381 requires the acquisition of assets of the loss corporation, the merging of a shell into another company pre-

*Mr. Eldridge presented a scholarly paper to the National Tax Association, of which this article is only a part. The entire paper is printed in the proceedings of the Forty-ninth Annual Conference on Taxation of the National Tax Association.

[1] Senate Committee on Finance, Report on Internal Revenue Code of 1954, 83d Cong., 2d Sess., pp. 52-53.

[2] Commodore's Point Terminal Corp., 11 TC 411

sumably would not enable the survivor to carry over losses.

One of the reasons for enacting specific limitations on loss carryovers in Section 382 was the ineffectiveness of the prior law, Section 129, in disallowing tax benefits where the purpose of acquiring a corporation was to evade or avoid tax.[1]

Section 129 of the 1939 Code provides that where a corporation is acquired by a person or other corporation not in control immediately prior to the acquisition, and the principal purpose is to evade or avoid Federal tax, the Commissioner is authorized to disallow the benefits of a deduction, credit, or allowance to the acquirer. Benefits are similarly disallowable where a corporation acquires from an uncontrolled corporation property having the same basis to the acquirer as to the transferor. Control means the ownership of at least 50% of the voting stock or the value of all shares.

It is not known to what extent this section may have been a deterrent to acquisitions for the avoidance of taxes, but it is clear that it has been unenforceable when contested by the taxpayer, largely because of the need to prove that the receipt of a tax benefit was the principal purpose of the acquisition. Until recently the Service lost all the cases brought to court under the section.[2] This provision has also been roundly criticized by tax students and practitioners because of its vagueness and uncertainty.

The former Section 129 was re-enacted as Section 269 of the 1954 Code, and with the intent of strengthening it a new subsection (c) was added. This subsection provides that, in the acquisition of a corporation or of property of a corporation not previously controlled, the payment of consideration substantially disproportionate to the tax basis of the property acquired plus the tax benefits, such as loss carryovers not otherwise available, shall be prima facie evidence of the purpose to evade or avoid Federal income tax. This provision is intended to apply where the consideration is considerably *less* than the aggregate of basis and the tax value of other benefits. It is not intended to apply where the limitations of Section 382 are applicable, but the fact that Section 382 may not apply in a particular area is not to affect the applicability of Section 269.[3] Thus, the general rule was continued of denying transfer of tax benefits between taxpayers where control of a business was acquired principally for the purpose of avoiding or evading tax.

Under the 1954 Code, as under the prior law, the rules for loss carryover by affiliated groups of corporations filing consolidated returns were left to regulations. The new Regulations continue to follow the same rules developed under prior law. When affiliated corporations file consolidated returns, the group is recognized in some respects as one business and taxpaying unit. As prescribed by regulations of long standing, current income and losses of corporations within the group may be offset, and the provisions for carryover are available for consolidated net offering losses against consolidated income of other years. But the Regulations have denied the privilege of carrying over a corporation's pre-affiliation losses and those incurred in separate return years against consolidated taxable income of other corporations. Where a corporation is in some years outside and in some years within a consolidated return, the regulations for loss carryovers in part treat the corporation as a separate taxpayer. Losses incurred by a corporation when filing separately may be carried over to years when the corporation is included in a consolidated return only to the extent that the specific corporation has taxable income.

These rules conform to the general principles of the consolidated returns regulations. The filing of such a return affords privileges and advantages for which a price has been imposed in the form of a special additional tax and the foregoing of other tax benefits such as separate surtax exemptions. Unrestricted use of loss carryovers among a group of corporations is allowed only for those who elect consistently to be treated as a single business unit. The same offsetting of different years' losses and income is not allowed among corporations which wish the advantages of separate returns in some years and of consolidated returns in others.

The Regulations for loss carryovers, however, are not wholly consistent in following the separate entity of a corporation which is in different years within and without a consolidated return. Current taxable income of a corporation which is brought within an affiliated group may be offset by a carryover of a consolidated net operating loss which was incurred by other corporations. In other words, the loss of a consolidated group may be carried over against the income of the group even though there are different components of the affiliated group in the income year.

By and large, however, the consolidated-returns Regulations appear to have been accepted as reasonable and have not involved as much controversy as the rules for carryover of losses to separate successor corporations.

1954 Code criticized

The 1954 Code has established a set of rules which (a) in part continue prior law by re-enacting the general principle of the old Section 129 and by delegating the authority to deal with consolidated returns through Regulations and (b) in part supersede the court-made rules which in several respects had proved unsatisfactory and inconsistent. With the objective of following economic realities rather than legal form, the 1954 legislation has expressly provided for loss carryovers to successor corporations under specific conditions. At some points the availability of loss carryovers under prior rules has been restricted.

However, the new rules have been criticized as providing a series of tests for the transferability of loss carryovers which are not necessarily consistent with each other in their application. The present rules seem to reflect several different bases for judging whether net operating losses should be acquired by a successor corporation. It may be helpful to ask: What are the rationales which seem to underlie the present set of rules?

Separate entities

In a broad way the concept of legal entity of a corporation continues to be used as a test for the allowance or denial of transfers of loss deductions. If a corporation is dissolved and goes out of business, its accumulated operating losses are not available for offset against the incomes of other taxpayers.

The 1954 Code also did not change the rules developed under prior law whereby a loss corporation may utilize its loss offsets against profits deprived from acquired businesses. In this area the traditional entity doctrine continues to prevail. Established losses of a corporation may be carried forward against new sources of profits developed by the

(1948); Berland's Inc., 16 TC 182 (1951); Alcon Wholesale Co., et al., 16 TC 75 (1951); Chelsea Products, Inc., 16 TC 848 (1951), *aff'd* 197 F. 2d 620 (3rd Cir., 1952); J. E. Dilworth Co., 98 F. Supp. 957 (1951). The exception is American Pipe & Steel Corporation, *supra*, 25 TC 35 (1955).

[2] Senate Committee on Finance, *op. cit. supra*, p. 284.

[3] *Op. cit. supra*, p. 284.

LOSS CARRYOVERS UNDER THE 1939 CODE

PRIOR TO 1954, the transferability of loss carryovers between corporations was in the main determined by court decisions and administrative rulings, among which there were several conflicts and inconsistencies.

Entity theory

Under the 1939 Code, a loss carryover usually was not transferable from one corporation to another. In 1934, Supreme Court sanction for the general rule was established in *New Colonial Ice Co.* (292 U.S. 435), where a new corporation succeeding to the assets and liabilities of another was denied the carryover of a net operating loss, since the two corporations were regarded as separate and distinct taxpayers.

Under this rule, if a profitable corporation acquired a loss corporation, no loss carryover would be allowed because the loss corporation had disappeared as a separate entity. On the other hand, if a profitable corporation was acquired by a loss corporation which continued as an entity, prior losses could be carried forward against any subsequent profits derived from the new and profitable business.

This application of the entity concept placed a premium on legal form and on the nominal survival of the loss corporation. In the case of the *Alprosa Watch Corporation* (11 TC 240 (1948)), a successor jewelry sales company was held to be entitled to the net operating loss of its predecessor glove manufacturing company even though the name, location, and stock ownership of the company had been completely changed. The shell of a glove corporation with a large loss, Esspie Glove Company, was acquired by outside interests as a vehicle for the sale of watches. The court decided that there was one taxable entity since the corporate charter, which remained unchanged, authorized the corporation to manufacture and deal in all kinds of merchandise.

In some cases, however, the courts were inclined to look through the technical question of the continuance of a separate legal entity in determining the availability of tax benefits. In 1939, in *Metropolitan Edison* (306 U.S. 522), the Supreme Court held that unamortized debt discount and expense incurred by a subsidiary could be amortized by a parent following a statutory merger in which the parent assumed all the pre-fusion debts of the absorbed corporation. The separate entity rule also appears to have been violated in *Stanton Brewery Inc.* (176 F.2d 574 (1949)), where the court allowed the carryover of the unused excess profits credits of two corporations which had been merged into a new corporation. The successor was regarded by the court as "the union of the component corporations into an all-embracing whole which absorbs the rights and privileges as well as the obligations of its constituents."

The separate entity doctrine would seem to preclude the carryback of net operating losses between corporations, and in the *Standard Paving Company* decision (13 TC 425 (1949), *aff'd*, 190 F.2d 330 (10th Cir. 1951)), the successor corporation in a Section 112(b)(6) merger was not allowed to carry back its net operating loss in a subsequent year to a predecessor corporation's last taxable period. The court followed the *New Colonial Ice* rule that the predecessor had ceased to exist. On the other hand, in *Moldit, Inc.* (C.D., N.D., Ill. (1953)), a surviving corporation in a statutory merger was held entitled to net operating carryback credits of two merged corporations by virtue of its own post-merger operating loss.

It may be noted that the limitation on carryovers in mergers produces somewhat asymmetrical results. If losses of a corporation absorbed in a merger are allowed to be carried over only to the extent of that portion of the successor's income attributable to the former loss component it might seem logical to impose a similar limitation where a loss corporation absorbs a profitable company. But under the Treasury interpretation of the 1939 Code, where a loss corporation was the acquirer in a statutory merger, its former losses could be carried undiminished to the successor corporation, which was treated as the same continuing entity.

corporation itself or obtained from another business which is purchased in a taxable transaction and merged in a tax-free liquidation.

A separate-entity theory is still followed in the treatment of the preaffiliation or separate-return-year losses of a corporation included in a consolidated return. Such net operating loss carryovers are limited to the amount of income attributable to the specific corporation even though it has become a component of an affiliated group.

To a degree, the entity theory may be regarded as persisting even in the present-law treatment of loss carryovers in tax-free reorganizations and mergers. But instead of legal form, the test is whether the taxable entity continues in some practical sense.

Intent to evade or avoid tax

The outright acquisition of one corporation's loss carryovers by another simply to reduce tax liability is regarded as wrong. The test here is largely one of subjective intent, which is difficult to prove. However, Section 269 of the 1954 Code C Section 129 or the 1939 Code) provides a general rule that the benefit of deductions may be disallowed if a corporation is acquired for the principal purpose of evasion or avoidance.

Transfer of loss carryovers

Some persons have suggested that the transfer of net operating loss deductions between corporate taxpayers would not be reprehensible if the acquirer did not enjoy substantial advantages. Subsection 269 (c) may be taken to reflect this view. Under this provision, the fact that a taxpayer paid a disproportionately small price for the use of a tax benefit is prima facie evidence of intent to avoid tax, and, unless the presumption is overcome, the benefit may be denied. Conversely, it might be inferred that if, in acquiring a corporation, a full price were paid for a tax benefit such as a loss carryover, the acquirer was not intended by the Congress to be regarded as trying to escape tax, and there would be no disallowance of the benefit under Section 269.

Continuity of business activity

One of the tests provided by the 1954 Code for disallowing the use of a loss carryover in corporate reorganizations was a failure to carry on the business which had incurred the losses. This view apparently sanctions the offsetting of losses of one corporation against gains of

a successor corporation which continues the type of business in which the losses had been sustained. A line is drawn, however, against averaging past losses against income from a wholly different kind of business.

This test is explicit in Section 382(a), which bars a net operating loss carryover if, in addition to a specified change of ownership within two years, a corporation has not continued to carry on a trade or business substantially the same as that conducted before. The Senate Finance Committee report indicates that this test includes changes in location, shifts from one type of business to another, or discontinuation of any except a minor portion of the business.[4]

Continuity of activity is also implicit in other provisions. It would be one consideration in the application of Section 269, for there would be more likelihood of construing intent as tax avoidance rather than bona fide business purpose where a loss corporation is acquired and its business activities discontinued. Moreover, the business-purpose requirement underlying tax-free reorganization might be in doubt if a loss corporation were acquired in a transaction involving a plan to abandon or discontinue that business. Unless the reorganization plan qualified, there would be no allowance of carryover of losses as provided by Section 381.

There is, however, no clear-cut and consistent manner in which a continuity-of-business-activity rule is applied. What constitutes substantially the same business under Section 382(a) may be variously interpreted, but apparently a relatively slight change could bar the use of the carryover. In contrast, a reorganization would probably not be invalidated if part of the acquired business were discontinued, as long as some substantial portion survived. Moreover, in a valid tax-free acquisition there is no requirement that the continuing business of the acquired corporation remain of the same type.

Time requirements

Time requirements also differ. The limitation of loss carryovers under Section 382(a) apparently would not apply if the change in a loss business were made after two years. But a plan to abandon a business as part of a reorganization plan, even though abandonment were postponed more than two years, might not satisfy the business-purpose requirement for a tax-free reorganization, and hence there would be no transfer of loss carryovers under Section 381.

Insofar as the continuity-of-business test applies under Section 382(a) and (b), it has an all-or-nothing effect. If, for example, a loss carryover is transferable in a corporate merger, the extent of the loss offsets is not limited to the continuing component of the successor corporation that formerly sustained the losses. Several profitable components may also be included in the merger, and in effect the loss carryovers may apply against their subsequent profits.

Continuity of assets

For purposes of classification, what is perhaps one facet of a continuing-business rule may be regarded as a separate test of the availability of carryovers. The 1954 liberalizing provision of Section 381 for the carryover of losses in certain tax-free liquidations and reorganizations applies only in cases of the acquisition of assets of one corporation by another.

A continuity-of-assets test was most fully developed in the Treasury position on carryover of losses in statutory mergers under the 1939 Code. The loss carryover would be allowed the successor corporation, but only to the extent of its income attributable to the net assets it had taken over from the predecessor loss company.

Continuity of ownership

At several points among the rules for loss carryovers to successor corporations there are outcroppings of the idea that the corporate tax is really on the shareholders and that tax benefits of loss deductions should be barred or limited with respect to a change of ownership. This view, of course, is at variance with the concept of a corporation as a separate entity with a life of its own, probably outlasting several generations of shareholders.

The Committee on Ways and Means, in enacting Section 382 of the 1954 Code, noted that the trafficking in corporations with operating loss carryovers was an abuse which permitted the exploitation of tax benefits by persons other than those who incurred the loss. The Committee sought to treat "a business which experiences a substantial change in its ownership, to the extent of such change, as a new entity for such tax purposes."

As modified by the Senate, Section 382(a) completely denies a loss carryover where more than half of the stock of a corporation is purchased by a few shareholders within a two-year period, providing also that the corporation then engages in a different type of business. This might mean, for example, increasing ownership from 20% to 70% of total stock. However, unless the same-business rule is also infringed, a loss carryover could survive a purchase of 100% of a corporation's stock.

In the case of tax-free reorganizations, The Senate Committee considered it appropriate to allow a carryover only if the shareholders of the predecessor corporation had a substantial continuing interest in the successor. The carryover is scaled down proportionately if that interest is less than 20% of the stock of the successor corporation.

Under Section 269 (Section 129 of the 1939 Code) the ownership test is one of acquiring control, i.e., merely crossing the line of owning 50% of the stock. In this case the degree to which tax benefits are denied is left to administrative discretion.

Conclusion

Mr. Eldridge then turned to the question of whether a single unified principle could be adopted and applied to all situations in which a loss carryover is transferred. Should the use of the loss be restricted to the corporate entity which incurred it? Should there be unrestricted transfer of losses? Should continuity of ownership be the test? Or continuity of the business enterprise? His conclusion was that each test has some advantages and some disadvantages. There needs to be more study and discussion of what is equitable in these situations; in all probability we will continue to have several criteria and formula that will provide only approximations. of the results desired. ☆

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Tax considerations should not govern "generally accepted accounting procedures"

"GENERALLY accepted accounting principles constitute such a large 'umbrella' that a wide variety of accounting practices may be covered by them" says* Peter A. Firmin, assistant professor of

* In a paper presented at the Ninth Annual Meeting of the Southeastern Section of the American Accounting Association held at the University of Georgia recently.

accounting at Tulane University. "It is therefore rather easy to relax vigilance and to allow tax and other considerations to dictate the utilization of a particular accounting practice, either because the umbrella is large enough to accommodate many practices or because the amount involved is "not material."

"There are certain areas of accounting practice in which this abdication of authority is more pronounced than in others. Prior to the enactment of the 1954 Code, for example, relatively few corporations thought it desirable to estimate future expenditures which should be classified as expenses of a current period. Auditors' statements did not distinguish between those corporations that did estimate expenses and those that did not—both groups maintained their accounts in accordance with 'generally accepted accounting principles.' With the advent of Section 462 of the Code, many corporations demonstrated admirable ability to estimate such expenses, and their published statements were prepared in accordance with 'generally accepted accounting principles.' Upon the subsequent retroactive repeal of the Section, many corporations returned to former policies of non-estimation—and the statements reflecting such a reversal of policy were in the great majority of cases prepared in accordance with 'generally accepted accounting principles.'

"By permitting the use of methods of depreciation other than the straight-line method and little-used declining balance procedure, the Code signalled for many companies a basic change in the method of allocating fixed property cost to operations. I have studied extensively the depreciation policies of over forty corporations represented by thirteen different firms of certified public accountants. In spite of the fact that the new methods of depreciation were adopted by many of these corporations, frequently upon the advice of the CPA firm involved, no instance was noted in which it was believed that the new methods of depreciation were inherently superior to the straight-line basis as a means of allocating plant and equipment cost to operations—except as a tax-deferring measure.

"These lapses in enforcement of generally accepted accounting principles are unfortunate. It matters not that the amount is not material, or that the tax-motivated change is still an acceptable practice. Non-accounting considerations generally should not govern accounting practice." ☆

New accounting decisions this month

Ordinary income on surplus bomb hoists [*Certiorari denied*]. The owner of a store selling ball bearings was unable to continue payments on a purchase of some 1,500 surplus bomb hoists. Taxpayer and another metal dealer each bought a third interest, advertised the hoists, distributed printed material through their regular salesmen and otherwise, and finally sold them—mostly to a junk dealer. The Tax Court held the income ordinary—the hoists were bought for immediate resale. One judge dissented on the ground that hoist sales were not continuous enough to be a business. Petitioner's attitude was far more passive than carrying on a business. The circuit court affirmed, although one judge dissented. He agrees with the minority opinion in the Tax Court. *Zack, cert. den.* 10/14/57.

Capital gain from sale of Groucho Marx show. From 1947 to 1950, Groucho Marx and John Guedel as copartners successfully produced a radio show entitled "You Bet Your Life," in which Marx was the star performer and Guedel the producer. In 1950 they offered to sell out their partnership interests, which included the name and general format of the show, to one or the other of two competing major networks. Both networks, NBC and CBS, bid one million dollars for the partnership interests, but as the additional amounts offered by NBC for the services of both Marx and Guedel were substantially greater than the amounts offered by CBS, the show was sold to the former. The Commissioner had determined that three-fourths of the million dollars received by the partners for their interests in the partnership was in fact compensation for services and taxable as ordinary income, because the sale was inextricably linked with the employment of the partners by the buying network. In rejecting the Commissioner's determination, the court finds that the partnership interests did have a fair market value of one million in view of the significant fact that two major networks arrived at that valuation completely independently of each other. It holds the entire million dollars taxable as long-term capital gain. *Marx*, 29 TC No. 13.

No goodwill in sale of professional business, IRS rules. Transferable goodwill does not attach to the business of a professional man or firm or to any other business the success of which depends solely upon the professional skill, ability, integrity, and other personal characteristics of the owner, although the courts have recognized that vendible goodwill may attach to a particular firm name. The Service therefore holds none of the proceeds of a sale of a professional business without a valid assignment of the right to the exclusive use of the firm name may be treated as the proceeds from the sale of goodwill. *Rev. Rul.* 57-480.

Jury finds royalty was partly compensation, partly for cancelling lease. Taxpayers received an overriding royalty agreement on certain property formerly under lease to them and at the same time canceled their leases on the property. The jury was asked to find the value of the royalty agreement and also to determine if it was received for cancelling the lease, in which event it would be capital gain, or as compensation for negotiating a new lease for the other party to the agreement. The jury found the value of the royalty agreement was $190,000 as against the $230,000 value for which the Government contended. It also found the royalty was given 50% as compensation and 50% for cancelling the lease. *Badgett*, DC Ky., 9/18/57.

No capital gain on subdivided realty where development and sales activities were substantial (Old Law). Over a five-year period, taxpayer made frequent substantial purchases of vacant, undeveloped land, which he subdivided and improved. During the two taxable years in question (1952 and 1953), a total of 31 lots and two parcels were sold in 24 transactions. Taxpayer's net profit amounted to about $63,000 on gross sales of about $117,000. This represented about 30% of his income. He argued capital gain on three theories: (a) His purpose in buying and developing the land was to provide work for the employees of his corporation during slack periods; (b) He was merely liquidating

his investments; and (c) His real estate broker handled all the details of platting, etc., and was not his agent but rather an independent contractor, since the broker bought the lots and sold them to his own customers. The Commissioner's ordinary income determination was upheld. Taxpayer held the realty for sale to customers in the ordinary course of his trade or business. The purpose for which property is held, not the purpose in acquiring, is controlling. This was not a case of a casual, isolated sale of real estate, but rather one of continuous purchases and sales, involving substantial activities and amounts. And taxpayer was deeply involved with his broker's sales—the latter's activities were the taxpayer's activities. It was obvious that, since taxpayer was buying more land, he was not liquidating, but rather continuing the business. [This was an old law case. Section 1237 of the 1954 Code provides capital gain for certain sales of subdivided realty.—*Ed.*] *Fowler,* DC Ohio, 9/24/57.

"Lease" held sale of land; "rent" is capital [*Certiorari denied*]. The taxpayer transferred land for a period of 68 years under an instrument designated as a lease. The lessee agreed to build a valuable building on the land, and had the option to acquire the land at the end of the lease for a payment of $10. The taxpayer contended that the amounts received, although originally reported on her tax returns as rent, should be treated as proceeds from the sale of the property. The Sixth Circuit agreed that the net effect of the transaction was a sale and not a lease. From the terms of the instrument, the true intent of the parties was to make a sale, even though the arrangement was called a lease and the payments were called rentals. Furthermore, the "lessee" was to acquire title to the property, and was acquiring an equity therein. Section 23 (a)(1)(A) of the 1939 Code specifically denies a rent deduction in such a situation. *Wilshire Holding Corp., cert. den.* 10/14/57.

Bank will have ordinary income on sale of real estate acquired through foreclosure. Real estate acquired by a bank upon foreclosure of mortgages (or by deeds in lieu of foreclosure) is, the IRS rules, property held for sale to customers in the ordinary course of its business (and not a capital asset). These properties were sold as soon as possible but sometimes improvement and development work was done and those activities were substantial. The IRS distinguishes GCM 24910, where such assets were held to be capital. That bank was forbidden by state law from carrying on real estate business and it acquired only three parcels and sold them within two years. GCM 26690 treated similar foreclosed property as used in a bank's business but that applied to a substantial number of rental properties managed by the bank. *Rev. Rul.* 57-468.

Subdivided farm land held for sale. A farmer inherited a tract of land and used it for many years as pasture. After World War II the tract appreciated greatly in value, and since the farmer had no personal experience in the real estate business, he engaged an independent contractor to plat, subdivide, and sell individual lots. After considering the frequency of sales and the activity of those acting for the seller, the court finds that the farmer held the lots for sale to customers in the ordinary course of the business of selling real estate. *Riedel,* TCM 1957-210.

Payments for exclusive right to collect scrap are capital expenditures. Taxpayer-corporation collected meat scrap and bones for rendering into tallow, grease, and glue. To insure a large and steady volume of raw materials into its plant, the corporation found it advantageous to effect agreement with individual sources of supply. The agreement called for a payment by taxpayer at the time of the agreement, as well as purchase of raw material collected at such prices as might be agreed upon from time to time. Taxpayer was designated as exclusive buyer. The court holds these rights were intangible capital assets, and the amounts paid at the contract signing are in the nature of capital expenditures, not ordinary and necessary business expenses. *Van Iderstine Company,* TC 1957-177.

Capital gain upheld on auto dealer's sale of company cars. Taxpayer-corporation, an automobile distributer, had in use by its employees, for company purposes, some 60 cars a year. These cars were, as a matter of business policy, sold after 10,000 miles of use, depreciation recorded, and the profits on the sale reported as capital gains. Similar handling existed with respect to cars it rented out to a subsidiary finance company. Taxpayer was, the court holds, entitled to treat its company cars in this manner, even though it was in the business of selling cars. These cars were not assets held primarily for sale in the ordinary course of its trade or business. *Massey Motors, Inc.,* DC Fla., 10/7/57.

Loss on sale of stock with whiskey purchase privileges a capital loss. Taxpayer, a wholesale liquor dealer, bought shares in a distilling company after it had announced a plan for permitting stockholders to buy its whiskey. Because it held the stock several years after availing itself of the whiskey-purchasing privilege, the court rules the stock was a capital asset at time of sale, and the resultant loss could not be taken as an ordinary business loss. *Gulftex Drug Co., Inc.,* 29 TC No. 16.

Amounts paid for covenant not to compete are ordinary income. Taxpayer and his brothers sold their stock in their wholly owned linen supply business for a fixed price and executed covenants not to compete for a separate payment. However, they reported both payments as capital gain. The court finds that the covenant was an agreement separate from the sale of the stock; that it was reached between the parties in arm's length negotiations; and that it correctly incorporated the consideration paid for it, which was severable from the price of the stock. It was ordinary income. *Ullman,* 29 TC No. 18.

DEPRECIATION

No amortization on bond issued with stocks for property; didn't prove discount applied to bonds [*Certiorari denied*]. Taxpayer issued bonds and stock for properties in a taxable exchange. The property had been appraised at less than the sum of the face amount of the bonds and the par of the stock and the bonds themselves were sold at the time at 85. Conceding that the taxpayer would be entitled to amortize any discount on the bonds issued for property, the court held that taxpayer failed to prove that the unquestioned discount was applicable to bonds rather than the stock. *Arkansas Missouri Power Co., cert. den.,* 10/14/57.

"Virginian Hotels" relief available to installment obligation on sale of over-depreciated property. The court is here asked to construe the extent of the re-

lief that Congress granted in 1952 when it abolished by statute the Supreme Court holding in *Virginian Hotels*. In that case, the Court held that the basis of property must be reduced by depreciation claimed on returns, and therefore allowed, even though it was excessive and resulted in no tax benefit. Congress provided that basis shall not be reduced by allowed depreciation in excess of allowable depreciation which resulted in no tax benefit (unless taxpayer elects to accept the reduction.) The taxpayer here received from its predecessor in a tax-free exchange certain installment obligations arising out of the predecessor's sale of an apartment house. It was conceded that the predecessor had no tax benefit during certain loss years for excessive depreciation and that the relief statute would apply to the building itself in the predecessor's hands. However, the predecessor had sold the building and reported the gain on the installment method. The taxpayer argued that the depreciation relief applied to the notes because the notes had, as their substituted basis, the building's basis. This court, reversing the district court, agrees. The predecessor could have elected to increase the substituted basis of the notes; taxpayer has the same right. *Mid-Century Ltd. of America*, CA-4, 6/29/57.

ACCOUNTING METHODS

Bonus constructively received by employee when he acquired corporate assets. In December, 1941, taxpayer agreed to buy all the assets of a corporation and to assume the liabilities. Simultaneously, a bonus was voted to him as an employee. When he acquired the assets later in December the court holds he constructively received the bonus. Receipt need not await actual disbursement from the bank account in 1942 because he had complete control of the account before the end of December. *Fraser*, DC *Mich.*, 10/16/57.

Accrual basis automobile dealer must include amounts retained in dealer's reserve account. A partnership engaged in the sale of used autos sold in its conditional sales contracts to a bank. It did not include in income amounts credited by the bank to the usual dealers' reserve account on the ground that the partnership was on the cash basis and not in constructive receipt of the credits. The court notes that the partnership uses inventories [Apparently inventories would be required under the regulation that they must be used if they are an income-producing factor.—*Ed.*] and the Regulations require use of the accrual method if inventories are taken. Therefore the Commissioner was justified in accruing the withheld credits. *Kilborn*, 29 TC No. 14.

Dealer's reserves income in year of credit. In accordance with its position in many previous cases, the Tax Court holds that an auto dealer's reserve account on the books of a bank is income to the accrual-basis dealer in the year credited, even though payment of the portion that went into the reserve account is postponed until a certain percentage level of unpaid contract balances is reached. The possibility that subsequent prepayments by purchasers of cars would reduce the amount in the reserve does not affect the accruability; such a reduction would be the consequence of a condition subsequent. *Morgan*, 29 TC No. 9.

Accrual basis car dealer not taxable on holdback by finance company. Taxpayer was an accrual basis corporation engaged in the retail automobile business. When it sold a car on time, it would discount its contract of sale (which included finance charges and insurance costs) to a finance company. It agreed to repurchase in the event of repossession. Taxpayer would receive from the finance company the price of the car, less the finance and insurance charges. The finance company set up reserves for these charges, which were not payable to taxpayer until each contract was fully paid. The finance company would hold back 5% of all outstanding contracts. Taxpayer is entitled to exclude from its income these reserve holdbacks. [The court makes no mention of the numerous cases in which the Tax Court has held these holdbacks cannot be excluded from income of an accrual basis taxpayer.—*Ed.*] *Massey Motors, Inc.*, DC Fla., 10/7/57.

Prior year's bookkeeping errors cannot be corrected in current year. Taxpayer was an insurance agency on the accrual basis. From 1930 to 1952 its books were kept by a clerk who had been shown the routine but who had no bookkeeping training. The clerk kept one control account for all accounts payable, including those to insurance companies. While she credited the account with premiums due to the agency from policyholders, she never entered the various corrections and adjustments (for cancelled policies, rate changes and the like). In 1953 it was discovered that due to the accumulated errors the accounts payable account was understated by some $23,000 and earnings overstated by the same amount. In 1953, when it discovered the error, the agency made an adjusting entry decreasing its commission income and increasing its accounts payable by that amount. The court holds the agency is not entitled to reduce its income of the current year because of bookkeeping errors which had resulted in an overreporting of income for prior years. *H. A. Carey Co., Inc.*, 29 TC No. 6.

Partnership, transferring assets, can't elect completed contract method. Taxpayer was controlling stockholder of a corporation organized to own land and build and sell homes on it. The actual construction work was to be done by taxpayer and other as partners. Toward the close of the partnership's first year it was clear the partnership would have a profit whereas another corporation wholly owned by taxpayer would have a loss. Taxpayer caused a new corporation to be formed to acquire both the assets of this profitable partnership and the stock of the loss corporation. The partnership elected the completed contracts basis and had no profit since none of its work was completed. The profit all appeared on the return of the successor corporation and since it consolidated with its loss subsidiary, escaped tax. The Commissioner sought to have the partnership report some of the profit by shifting the accounting for income from the completed contracts method to the percentage of completion method. On the grounds that a short-lived partnership cannot establish a consistent practice of reporting long-term contract income by the completed contracts method, and that this method does not clearly reflect the income of a transferring entity, the court holds the partnership could not avoid its ratable share of the construction profits by adopting the completed contracts method. *Palmer*, 29 TC No. 21.

Taxpayer avoids double taxation on receipts while changing from accrual to

installment method. The 1939 Code and the 1954 Code require a taxpayer electing to change from the accrual to the installment method of reporting income to include all amounts actually received during the installment year. This results in a double tax on income which had been previously accrued. Taxpayer's subsidiaries (filing a consolidated return with taxpayer) discounted their installment accounts receivable with two banks and reported the sale in a consolidated return in a prior year. Thereafter they all changed to the installment method. The Commissioner included in their income for their years on the installment method the collections on the discounted notes, actually received by the banks, on the ground that the notes were not sold but merely pledged as collateral for loans. The court holds that the installment receivables were sold. The subsidiaries retained no interest in the notes discounted and received no collections on the installment accounts during the taxable year. *City Stores Co.*, DC Pa., 9/13/57.

Successor to bankrupt may deduct wages paid, though bankrupt has previously accrued and deducted them. Taxpayer, a successor to a railroad in receivership, paid retroactive wages under an agreement signed several months after it took possession. The liability for this payment had been accrued by the bankrupt and deducted on its return. The Commissioner argued that taxpayer merely paid off an obligation of the bankrupt and had no deductible expense at all. The court holds, however, that no liability existed until the final signing of the wage agreement; any prior agreements were not binding on a corporation in receivership because there was no court approval. Therefore the predecessor had no right to accrue the liability, and the taxpayer's deduction is proper. *Minneapolis & St. Louis Railway Co.*, DC *Minn.*, 10/8/57.

Cash basis seller has no income on sale of stock; proceeds had to be lent to corporation. Taxpayer had agreed to sell his stock in a mining company and had promised the prospective buyer that the proceeds of the sale would be lent to the mining company as a loan on open account. The court holds that taxpayer, on the cash basis, did not realize any income in the year of sale in the absence of a showing that the proceeds were made immediately available to him. Four judges dissent; they would keep the sale and the loan entirely separate, pointing out the difficulties that will arise in determining when the gain is to be recognized. *Williamson Estate*, 29 TC No. 8.

Insurance proceeds accruable when damage determined and dispute settled. Six days prior to the close of taxpayer's fiscal year in 1946 a fire occurred on its premises. Insurance recoveries received in the following fiscal year for fire, water, and business interruption losses are held not to be properly accruable in the year of the fire but are to be included in the following year's income. The extent of the damage had not as yet been determined at the end of fiscal 1946, and there was a bona fide dispute with the insurance companies which was not settled until the year of recovery. *Thalhimer Brothers, Inc.* 27 TC 733, *acq.* IRB 1957-41.

Tax returns must be on accrual basis when books are; can't defer expenses to match income [*Acquiescence*]. Although taxpayer's professional engineering partnership changed from the cash to the accrual basis in keeping its books, it continued to file its returns on the cash basis. The court held the firm income should have been reported for tax purposes on the accrual basis, the same basis employed in keeping the books. Amounts billed but not received are therefore income. Deductions for expenses actually incurred on jobs in progress. However, the Commissioner erred in postponing expenses until billing so as to obtain a precise matching of income and expenses. An accrual-basis taxpayer must deduct all expenses on jobs (except for reimbursable expenses which are in the nature of loans) when incurred. *Patchen*, 27 TC 592, *acq.* IRB 1957-41.

Cargo loss deductible in year sustained even though erroneously deducted in barred years. [*Acquiescence*]. A common carrier on the accrual basis incurred net losses of $127,000 in 1948 from cargo and loss damage. It conceded that part of the loss was erroneously deducted in earlier years which were barred by the statute of limitations. Taxpayer is nevertheless allowed a deduction for the full loss in 1948. The court did point out that the Commissioner had an adequate remedy under Section 1311 to open up the earlier years, after the decision becomes final, because of the inconsistent position taken by taxpayer. *Kenosha Auto Transport*, 28 TC 481, *acq.* IRB 1957-41.

Refunds from utility-rate change accrue when change is accepted [*Certiorari denied*]. Taxpayer, a public utility, during the period November 15, 1949 through November 14, 1950, collected from its customers under bond over $2,000,000, which represented the difference between rates in effect prior to November 15, 1949 and rates fixed by a 1949 city ordinance. These amounts it included in gross income. The utility appealed the 1949 ordinance before the State Public Utilities Commission and, to settle the dispute, the city adopted in 1950 a new schedule of rates for the period in controversy. The new schedule, dividing the $2,000,000 about equally between the customers and the taxpayer, was accepted by the utility and approved by the voters in 1950. The Public Utilities Commission entered, in 1950, its order to make refunds in that year, but the refunds were actually made in 1951. The Sixth Circuit held that the amount refunded to the customers was deductible in 1950 when all the events occurred to fix the company's liability. *Columbus and Southern Ohio Electric Co., cert. den.*, 10/14/57.

Can't switch to completed contract after reporting on accrual basis [*Certiorari denied*]. Taxpayers were members of a joint venture constructing a Japanese relocation center under government contract. The partnership return for 1942 reported income on an accrual basis. Amended returns for 1942 and 1943 were filed in 1947 reporting all the income from the contract in 1943, the year in which it was completed. Taxpayers argued that the 1942 accrual-basis return was wrong because the joint venture accounted for its income on the completed-contract method, and they then had the mistaken idea that the job had been completed in 1942. The Ninth Circuit held that the accrual method was intentionally adopted and was binding; taxpayers could not have had any doubts that the contract was not completed in 1942. *Daley, cert. den.*, 10/14/57.

Compromise after consent to tax assessment does not affect interest accrual. After consenting to a tax assessment, taxpayer in a subsequent year entered into a compromise agreement providing for deferred installment payments of the

assessment. The Service holds that the compromise agreement in no way affects the time for accrual of the taxpayer's liability for interest. *Rev. Rul.* 57-463.

Self-insurer may not accrue anticipated personal injury claims. An expense accrual for anticipated payments of personal injury claims pending at the end of the year is not deductible where the claims are contingent rather than actual. *Rev. Rul.* 57-485.

Price indices for July 1957. Bureau of Labor Statistics price indices for July, 1957, are acceptable by the Service for use by department stores using the retail and LIFO inventory methods. *Rev. Rul.* 57-515.

DEDUCTIBILITY

Over-ceiling wages disallowed. [*Certiorari denied*]. Taxpayer, a building contractor, paid wages to its plasterers higher than permitted under the Defense Production Act. Under the authority of the Defense Production Act these excessive wage payments were disallowed for income tax purposes. The Court of Claims upheld the deficiency. The opinion pointed out that the Code allowed as deduction "a reasonable allowance" for salaries and wages. The taxpayer contended that where, as here, the wages are part of the cost of goods sold they cannot constitutionally be excluded in computing income. *Pedone, cert. den.*, 10/14/57.

Some signs expense; others capital. Taxpayers had signs made for advertising their business on paper, on plastic and on metal. The court holds that the paper signs are a deductible business expense. The metal and plastic signs are capital investments. The record showed that the paper signs lasted less than a year, while the plastic and metal signs lasted more than a year. *French Broad Ice Cream Co.*, DC Tenn., 9/9/57.

OPA treble damages not deductible; were due to negligence. Taxpayer made many mistakes in setting its price under OPA. The net result was substantial overcharges. It settled by paying OPA $410,000 treble damages. Subsequently, it discovered an additional $4,000 violation and made a voluntary payment. These payments were designated as penalties and taxpayer cannot here attack that finding by trying to show it settled only to avoid publicity. Penalties are not deductible and moreover, taxpayer cannot come under the rule permitting deduction of OPA penalties for innocent mistakes. The taxpayer was guilty of gross carelessness in its OPA computations, including costs twice, etc. *A. D. Julliard & Co.*, DC N. Y., 10/22/57.

Beer dealers can't deduct expense of campaign to defeat legislation by referendum. Taxpayer, a wholesale beer distributor, contributed to a fund which beer and wine dealers established to defeat, by publicity, proposed legislation which would place retail beer and wine sales in state-owned and operated stores. The proposal was in the form of an initiative or referendum measure. The district court held that the Regulations have long provided that funds spent to influence legislation are nondeductible. Whether the funds are spent to influence members of a legislature or the general public with respect to an initiative measure is immaterial. This court affirms, noting that since taxpayer was a wholesaler, there was no showing that the proposed legislation would affect his business. *Cammarano*, CA-9, 7/8/57.

WHAT IS INCOME?

Insurance renewal commissions ordinary income to widow. [*Certiorari denied*]. Taxpayer, the widow of an insurance man, received renewal commissions on insurance sold by her husband prior to his death, and similar renewal commissions that had been assigned to him (he "purchased" the renewals from other agents). The Seventh Circuit held the collections are income in respect of a decedent under Section 126 of the 1939 Code, but permitted her to amortize part of her husband's cost of the agency and renewal commission contracts against the income received therefrom even though there was no mathematically accurate basis for computation of such allowances. It also included in the widow's income renewal commissions retained by the insurance company as repayment of advances it had made under the agency contracts. *Latendresse, cert. den.*, 10/14/57.

Corporation's payment to president's widow a nontaxable gift. Payment by a corporation of $5,000 to the widow of its deceased president is held to constitute a gift in recognition of the monumental services her deceased husband had rendered the corporation for which he was fully compensated during his lifetime. The family of the president owned over 80% of the stock of the corporation. The court rejects the Commissioner's argument that the payment was taxable to the widow either as a dividend or as compensation for past services. *Maycann Estate*, 29 TC No. 12.

Awards to faculty members for outstanding service taxable. An educational institute gave cash awards to certain of its faculty members on the basis of outstanding service, as a supplement to their salaries. The Service holds such awards taxable to the recipients even though paid from funds specifically donated for that purpose. Awards in recognition of outstanding service are nontaxable only if the recipient is selected without action on his part and is not required to render substantial services as a condition of the award. The Regulations have taken the position that awards by an employer to employees do not meet these conditions and are taxable. *Rev. Rul.* 57-460.

Transfer of appreciated property to trust for divorced wife nontaxable unless in discharge of money obligation. A husband realizes no taxable income by transferring appreciated stock in trust for the benefit of his divorced wife for life with remainder to a charity. Amounts paid to the wife by the trust are not included in the husband's gross income and consequently are not allowable deductions to him. The transfer of the remainder interest in the stock constitutes a charitable contribution by the husband. *Rev. Rul.* 57-506. But if a husband has a definite obligation to his wife under a separation agreement, and transfers property to an irrevocable trust providing that the income from the trust is to be credited against the amounts which the husband is obligated to pay to his wife, then the husband will realize taxable income on transfer of appreciated property to the trust. Should the remainder interest be given to a charity, only the appreciation applicable to the portion used to pay the debit will be taxable; a deduction will be allowed for the value of the remainder. *Rev. Rul.* 57-507.

Bonds of Mystic Bridge, Mass. Turnpike, are exempt. The IRS holds that the Mystic River Bridge Authority and

the Massachusetts Turnpike Authority are both political subdivisions of a state and therefore interest on their bonds is exempt from Federal income tax. *Rev. Rul.* 57-308.

OTHER DECISIONS

Earnings taxed to earner, not his assignee [*Certiorari denied*]. In 1932 taxpayer assigned his insurance commission contract to his wife. The Seventh Circuit said this case is identical with *Eubank* in which the Supreme Court held that an insurance agent could not avoid tax on income already earned by assigning it to another. *Hall, cert. den.*, 10/14/57.

Remittance of previously blocked income on first-in first-out basis. A taxpayer who properly elected in prior years to defer the reporting of blocked foreign income must include a partial remittance of such income in taxable income in the year received (with proper deductions allocated thereto), on the basis of the first-in first-out rule. *Rev. Rul.* 57-379.

Dealer's reserve account income to seller of commercial paper when credited. Taxpayer was a member of an accrual basis partnership dealing in house trailers. It sold its conditional sales contracts to a finance company. Amounts retained by the company and credited to a "dealer's reserve" account (which sums were eventually paid to the partnership when the contracts were paid in full) are held to constitute income to the partnership in the year of credit. The Tax Court notes that the Fourth Circuit has held otherwise in *Johnson*, 233 F.2d 952, but continues to hold the opinion it has expressed in many similar cases. *Baird*, TCM 1957-192.

Proceeds received under claim of right taxable though repaid in later years. Taxpayer had received stock of a new corporation for his services in promoting it. He sold these shares in 1951 and in 1952 suit was begun by an associate who claimed ownership of some of them. A state court held for the associate. Taxpayer argued he was entitled to reduce the proceeds from sale of stock, as reported in his 1951 return, by the amount of money which he was obliged to refund in 1953 pursuant to the judgment of the state court. The Tax Court holds, however, that the proceeds were received under a claim of right in 1951 without restriction as to their disposition, and they were fully taxable in that year. *Phillips*, 29 TC No. 7.

Loss denied upon failure to establish basis. Upon dissolution of a corporation, taxpayer received certain assets as a liquidating distribution. Since taxpayer was unable to show what the fair market value of the assets were on date of distribution, he is held not entitled to claim a loss thereon. *O'Neill*, TCM 1957-193.

Stock value not affected by tax deficiencies assessed after sale. A minority stockholder purchased all the remaining corporate shares in 1949, paying $10,000 in cash and $30,000 in other property. He contended that the stock was worthless in 1949 and he should be allowed the loss in that year. Deficiencies and penalties of more than $40,000 were assessed against the corporation in 1953, for fiscal years ending prior to 1949. The court holds the stock was not worthless in 1949. Subsequent events could not be taken into consideration in determining fair market value as of the time of the prior transaction. *Koyl*, TCM 1957-130.

Basis for depreciation of acquired property was cost and not estimated replacement cost. Taxpayer, pursuant to a lease option, purchased a plant in 1939 for $43,000. In 1951 it claimed the correct basis of the plant was $353,000, the estimated replacement cost, and used that increased basis to compute depreciation. Taxpayer argued that the action was proper, inasmuch as the seller of the property wanted to have taxpayer settle in the community and intended to make a capital contribution of the difference between the original sales price and the greater replacement value. The court rejects the argument and holds taxpayer must continue to use cost for depreciation in the absence of any proof of an intended gift or contribution to taxpayer's capital. *Dumont-Airplane*, 28 TC No. 157.

Irrigation system still used; no abandonment loss. A farm partnership purchased property with rights to an irrigation system run by a farmers' cooperative. The partnership later decided to irrigate its property by means of wells rather than from the irrigation ditch. On its tax return it claimed $20,000 as an abandonment loss of the ditch. The court finds no abandonment during the year in issue since the firm continued to use and maintain the ditch, and paid the annual irrigation assessment levied by the cooperative. *Beus*, 28 TC No. 132.

Goodwill deductible as ordinary loss in year business abandoned. If a corporation abandons a business and all its assets, including goodwill, the corporation's basis for the goodwill is deductible as an ordinary loss. Should the deductions for the year of abandonment, including that for goodwill, exceed the gross income, the excess is available as a net operating loss. *Rev. Rul.* 57-503.

Loss on sale of breeding herd not net operating loss (Old Law). Taxpayer, a farmer-rancher, regularly bought and sold cattle. In 1951 he acquired a herd of breeding cattle as a separate business. When he was advised early in 1952 that the herd was diseased, he decided to discontinue the breeding operation, to fatten the breeding cattle, and to sell them for beef as soon as possible. The court holds the loss on sale of the breeding cattle was not a net operating loss resulting from the "operation of a business" as required by the 1939 Code but rather resulted from a "termination" of a business. Four judges dissent on the ground that taxpayer did not sell these diseased cattle as a liquidation of a breeding business; what he did was to transfer the cattle to his "commercial" herd, and sell them as part of the ordinary commercial business. The court does allow the loss on sale of a combine as an operating loss because that loss was purely incidental to the farming business and did not result in any diminution of that business. [Under the 1954 Code losses from the disposition of property used as a business are included in operating losses. *Ed.*]*Cluck*, 29 TC No. 2.

Joint acquisition of stock of corporation owning similar property not a replacement. Two corporations, with identical stockholders, received payments from the state because of involuntary conversion of property. They propose to invest the proceeds in stock of a new corporation owning similar property. The Code treats as replacement the acquisition of more than 80% of the stock of a corporation owning similar property. The IRS rules that the proposed acquisition does not qualify as a proper replacement because each corporation's purchase of the new stock will not be acquisition of 80%. *Rev. Rul.* 57-454.

MANAGEMENT OF THE

Professional tax practice

AND PROFESSIONAL AFFAIRS OF LAWYERS & ACCOUNTANTS

Should practice before IRS be treated in same way as before regulatory agencies?

THE FUROR created by the Hoover Commission's recommendation on reorganization of legal services and procedure in the Federal Government has resulted in several (as yet unsuccessful) efforts to implement these recommendations by legislation. Proposed legislations by legislation.

While matters of important principle respecting administrative law are involved here, the primary interest to tax men is (1) the effect such changes would have on rights to practice before Treasury and Tax Court, and (2) the question of abolishing the Tax Court and moving its functions to the recommended Administrative Court of the United States.

Study of the recommendations themselves, together with many comments by persons and organizations close to the matter, raises the question of whether tax practice and administration should be lumped together with regulatory agencies. For example, the Staff Report on Legal Services and Procedure of the House Judiciary Committee pointed out that "It must be remembered that the independent regulatory agencies were established to energetically and independently enforce legislatively determined policies. The first Hoover Commission clearly recognized the independent nature of these regulatory agencies. Their status in this regard is basically different from that of an executive department and this difference is relevant to the proposals which would give greater control over agency lawyers and agency legal matters to the Attorney General." It has often seemed to your editors that efforts to include the IRS with all other administrative agencies of the Federal Government ignored important differences between them in function and operation.

No other administrative agency of the Government, for example, deals with so many persons (individual or corporate) so frequently and on matters of such large financial importance. No other administrative agency has anything like the number of professional advisors representing its "subjects."

In the matter of practice, the difference between the IRS and other administrative agencies is the nature of the pressures affecting the right to practice. In taxes, the conflict is generally between lawyers and accountants; in other agencies the lawyers share rights to practice with a number of other types of advisors, both numerically fewer and organizationally less strong than either the lawyers or accountants. One consequence of this is that in tax practice the pressures are strong and feelings sometimes run high. It may be that in taxes law and another skill are no more intertwined than in patent law or in Interstate Commerce Commission questions, but certainly determining the "practice of law" in taxes is no easy matter. The right of lawyer or accountant to practice his own profession in taxes is not easy to limit or define.

Current legislative proposals

The nature of the current legislative proposals is well set forth by Rep. Francis E. Walter, member of Congress from Pennsylvania, and himself a lawyer. Writing last month in *Dicta** he pointed out that the second session of the 85th Congress which will convene on January 7, 1958, will probably witness a renewal of at least one old struggle, that of who is to be allowed to practice before Federal administrative agencies and under what limitations, if any. "Embodied in various proposals," he said, "the problem has been before the Congress for many years. Legislation has for years been proposed in the Congress on the subject of admissions to practice before administrative agencies. Some 20 bills have been introduced in recent years.

"More recently, the Hoover Commission made a series of recommendations in this area. Many of these had been the subject of prior legislative proposals and had received at least committee study in Congress. The current precipitant of the issue is HR 3350, and S 932, a companion bill in the Senate. These bills are the result of the Report of the Special Committee on Legal Services and Procedure of the American Bar Association. In addition to creating an independent office of Federal Administration Practice, establishing a legal career service for Government lawyers, and revising the laws governing hearing examiners, these proposals would also affect procedures and standards for admission to practice before Federal agencies.

Bill requires lawyer representation

"Section 402 of HR 3350 requires representation by a lawyer in any 'agency hearing required under the Constitution or by statute to be determined on a record which is subject to judicial review.' It also precludes non-lawyer representation in any matter which involves 'the practice of law.' The effect of these provisions on non-lawyers acting in a representative capacity before Federal agencies is far-reaching and deserves the most careful study before any action is taken thereon. The provision relating to judicially reviewable hearings would affect substantial non-lawyer interests in Tax Court, ICC, and Railroad Retirement Board proceedings, to mention only a few of the areas of non-lawyer representation.

"Is it desirable that non-lawyers be barred from these kinds of proceedings? In favor of the proposal, it is argued that the agency, the practice and the courts would all be benefitted by utilizing the training and skill of a lawyer in making a relevant, concise and meaningful record for review. Agency proceedings would be shortened and appellate courts would receive a record susceptible of expeditious and equitable desposition.

"On the other hand, there are skilled tax accountants who have, over a period of years, developed a thorough grasp of Internal Revenue procedures and who have a compendious knowledge of tax regulations and policies.

"An even more difficult problem is presented by the prohibitions against

'the practice of law.' What is 'the practice of law'? Is representation in rate-making, carrier certification and tax deficiency proceedings 'the practice of law'? At present, the various agencies derive from the acts creating them the power to regulate practice before them. These acts do not exclude non-lawyers. However, should legislation be enacted qualifying this authority and barring 'the practice of law' without defining it, then the prospect is one of litigation and uncertainty. While the term 'practice of law' has been frequently defined by the courts, there is no unanimity of definition and it is doubtful whether it would be desirable to adhere to some of the definitions already declared, e.g., The Unauthorized Practice of Law Committee of the Kentucky State Bar Association has announced in an advisory opinion that 'the minute a single act is done to a tax return the party so doing is practicing law.'

"Certainly, it is undesirable to permit those who are untrained and unskilled in legal problems to hold themselves out to the public as competent. Certainly it is not desirable for either the parties or the agency or the appellate tribunal to have certain proceedings conducted by non-lawyers. But is the term 'practice of law' the most effective standard? Ultimately, the question should be decided by the criterion of whether in a particular type of proceeding the lawyer or the non-lawyer expert is best equipped to give effective representation to his client. Can these be done best by allowing the individual agency to determine the answer for its own specialized proceedings or can it be done best by barring 'the practice of law,' with or without definition, by an omnibus act?"

CPAs protest

Enactment of S 932 "would result in a broad and sweeping interference with established methods of transacting business with the Government," wrote Marquis G. Eaton, president of the AICPA to Senator Lyndon B. Johnson earlier this year.

The bill, says Mr. Eaton, "introduces a radically new concept of representation before Federal agencies. Anybody except a lawyer who represents individuals, associations and business firms would be subject to severe limitations in informal discussions and administrative proceedings conducted by Federal agencies.

"Restrictive and objectionable provisions of this bill appear to apply to the vital and customary activities of chambers of commerce, labor unions, farm organizations, corporate officials (including corporation officers and directors), engineers, veterans' representatives, Interstate Commerce Commission practitioners, labor relations consultants, manufacturers' agents, custom-house brokers, cost accountants, certified public accountants and many other experts.

"Another serious result of such legislation could well be a costly and demoralizing interference with the collection of Federal revenues. The whole purpose of certain long-established practices of the Internal Revenue Service—those resting upon informal discussion between taxpayers' representatives and the Government—would be defeated if the presence of attorneys on both sides were required and formal proceedings were made the rule rather than the exception. The Government would suffer, and the taxpayer would suffer."

Bar Assn. favors new law

Lawyers in general tend to favor the proposed legislation, accountants generally to oppose it, each for obvious reasons. The Bar's sympathy with the problems involved is suggested by Valentine B. Deale, of Washington, who is chairman of the Special Committee on Office of Federal Administrative Practice Act of the American Bar Association. He says "When lawyers close their ranks and sponsor legislation affecting the rights of anyone who represents others before Federal administrative agencies it is entirely understandable that their efforts might be regarded apprehensively by some accountants. However, regardless of unthinking suspicion, popular prejudices and other nonsense about the relations between accountants and lawyers, your own group (National Society of Public Accountants), at least as I understand its interests, has no grounds for apprehension about the subject of legislation."

Effect of judicial review

In a legal memorandum, prepared for the AICPA, commenting on the bill, Mathias F. Correa, New York attorney, considered the effect of the bill on practice before the Tax Court. He said the bill "provides that every participant is entitled to be represented before any agency in any matter by an attorney-at-law or at his or its election, may in addition or in the alternative be represented before any agency in any matter *which does not involve the practice of law* by persons specially authorized to practice by that agency under Section 410. (emphasis added)" [It] . . . "goes on with a proviso that except in the case of an individual representing himself, no party to an agency hearing required under the Constitution or by statute to be determined on a record which is subject to judicial review, shall be represented except by an attorney-at-law.

"This provision would exclude representation of participants by non-lawyers in most types of formal adversary agency proceedings. A typical illustration would be the Tax Court of the United States. It would also seem that this provision would preclude representation of a corporation or other form of business organization in formal adversary proceedings by an officer of such organization. Similarly, it would seem that the definition section and the first sentence of Section 402 would preclude an officer of a corporation or other form of business organization from representing his organization in any matter which involved the practice of law." ☆

IRS issues rules on reproduction of tax returns

THE INTERNAL REVENUE SERVICE has restated its requirements for the reproduction of tax returns and schedules filed with it. With the rapid growth in recent years of use of mechanical processes for filling-in and duplicating returns, these rules of the IRS are of widespread interest. The new rules appear in Rev. Proc. 57-37, published in the Internal Revenue Bulletin, 1957-47, November 25, 1957.

Essentially the same as the previous rules, there are a few changes. The new rules give effect to the announcement last year that now reproductions must substantially duplicate the colors of the official form in order to be acceptable.

The new rules require that forms and returns must be the same size as official forms, subject to a table of permissible tolerances. This is going to require greater care in trimming and folding of reproduced documents.

The Service will, as in the past, consider applications for reproduction of forms not on the approved list. It will also pass on the acceptability of doubtful reproductions. ☆

NEW DEVELOPMENTS IN

Payroll taxes

EDITED BY PETER O. DIRR

Voluntary contributions to unemployment insurance offer advantages to employer

WITH THE NEW state legislative sessions soon beginning, the time is now appropriate to consider the case for voluntary contributions.

Voluntary contributions represent employer unemployment insurance tax payments in excess of the amounts required under the assigned tax rate schedule. Generally, such payments serve three distinct purposes, namely:

1. Permit an employer to "time" his tax payments to suit his convenience. He may find it advantageous to pay additional taxes in the current year rather than in one or more subsequent years. For example, an employer enjoying a very profitable year with a subsequent poor year expected to follow should be permitted to make greater contributions to the reserve fund during his profitable year with the prospect of securing a lower unemployment insurance rate and thereby minimizing the expense in his unprofitable year.

2. Permit an employer to minimize the effects of one year of particularly poor benefit experience.

3. Permit an employer to sometimes effect a possible saving in taxes. Such saving may be important from the short-term view point. Over a period of years, however, the relative saving is minimized.

The basis for the possible saving is the fact that rate schedules provide given tax rates for specified ranges of the reserve ratio. When an employer's reserve ratio happens to fall near the top of a bracket, a small voluntary contribution, added to his reserve fund, may save several times the amount of taxes for the next year.

If this is done in successive years, so that an employer repeatedly moves up from the top of a lower bracket to the bottom of a higher bracket, some minor long-term saving may be possible. Possibilities vary with the size of the bracket in the schedule, as well as the size of the steps between one rate and another.

Generally, however, voluntary contributions are averaged out over a period of four or five years. This averaging out idea is best illustrated by reviewing the actual examples given in the table above, taken from the files of a particular employer.

It will be noted that in State A there was a saving of little more than 1% over a five-year period, while in State B, it was slightly less than 5%.

These examples indicate that, by and large, savings effected through voluntary contributions average out over a period of three, four or five years.

It is well to dispel the idea that where voluntary contributions exist employers rush pellmell to effect huge savings under the program. The facts do not support any such contention. The chart below shows the experience in selected states for the calendar years 1954 and 1955. This chart shows the percentage of voluntary contributions in the state in relation to total employer contributions. They are not very substantial. It also shows that, in most cases, the payment of voluntary contributions has little or no effect on the state average tax rate. (It generally only affects the individual employer's tax rate.)

Aside from the employer viewpoint, voluntary contributions are a desirable feature of a state unemployment insurance law because they:

1. Overcome the sometimes arbitrary and inflexible results which are

EXAMPLES FROM EMPLOYER FILES

STATE A

Year	Taxable Wages	Voluntary Contribution	Contribution Rate	Contribution	Expense
1952	$260,156.84	$ 800.00	0.0	$ -0-	
1953	268,677.28	1,350.00	0.0	-0-	
1954	247,506.57	1,800.00	0.0	-0-	
1955	256,841.24	-0-	0.9	2,311.57	
1956	251,904.27	500.00	1.0	2,519.04	
		$4,450.00		$4,830.61	
	Total expense with voluntary contribution				$9,280.61
1952	$260,156.84	$ -0-	0.9	$2,341.41	
1953	268,677.28	-0-	0.0	-0-	
1954	247,506.57	-0-	0.9	2,227.56	
1955	256,841.24	-0-	0.9	2,311.57	
1956	251,904.27	-0-	1.0	2,519.04	
				$9,399.58	9,399.58
	Net Saving				$ 118.97

STATE B

Year	Taxable Wages	Voluntary Contribution	Contribution Rate	Contribution	Expense
1952	$274,699.42	$ 775.00	0.6	$ 1,648.19	
1953	286,514.48	1,000.00	0.6	1,719.09	
1954	284,507.80	675.00	0.6	1,707.05	
1955	286,989.65	-0-	0.6	1,721.94	
1956	297,230.32	-0-	0.6	1,783.39	
		$2,450.00		$ 8,579.66	
	Total expense with voluntary contribution				$11,029.66
1952	$274,699.42	$ -0-	0.95	$ 2,609.64	
1953	286,514.48	-0-	0.95	2,721.89	
1954	284,507.80	-0-	0.95	2,702.82	
1955	286,989.65	-0-	0.6	1,721.94	
1956	297,230.32	-0-	0.6	1,783.39	
				$11,539.68	$11,539.68
	Net Saving				$ 510.02

State	1954 Voluntary Contributions As % of Total Employer Contribution	1954 Average Tax Rate Excluding Voluntary Contribution	1954 Average Tax Rate Including Voluntary Contribution	1955 Voluntary Contributions As % of Total Employer Contribution	1955 Average Tax Rate Excluding Voluntary Contribution	1955 Average Tax Rate Including Voluntary Contribution
Colorado	0.25	.38	.38	0.52	.34	.34
Iowa	0.99	.37	.38	1.03	.41	.42
Missouri	1.51	.66	.67	3.89	.79	.82
Nebraska	4.82	.58	.61	2.95	.63	.65
New Jersey	0.89	1.51	1.52	0.84	1.53	1.54
North Carolina	1.75	1.52	1.54	0.61	1.12	1.13
Ohio	0.76	0.61	0.61	0.52	0.67	0.67
Oregon	0.62	1.17	1.18	0.64	1.22	1.23
Wisconsin	6.93	0.79	0.84	5.70	0.95	1.01

derived when dealing with percentages in assigning tax rates.

Example:

	Employer A	*Employer B*
Account balance	$ 11,440	$ 11,500
Payroll	100,000	100,000
Reserve ratio	11.44%	11.50%
Assigned rate	0.9%	0.7%
Tax expense	900	700

Employer A, by making a voluntary contribution of $60, could bring his account balance up to that of Employer B, thereby securing the same favorable contribution rate and effecting a short term tax saving of $140.

2. Overcome, to some extent, the many factors which enter into the determination of an employer's contribution rate over which he has no control. For example, the date on which a claimant first files for benefits and the amount of benefits received by him in a given fiscal year could affect the employer's assigned rate for the next tax period.

3. Encourage employer interest. Recently Stanley Rector, Executive Director of the Unemployment Benefit Advisors, stated: "The opportunity to make voluntary contributions may be considered to be an important part of effective experience rating by furnishing an additional area of employer interest in the U. C. Program."

Voluntary contributions are presently permitted in 23 jurisdictions with reserve ratio formulas and in two states (Minnesota and Wyoming) with a benefit ratio system.

Eleven taxing jurisdictions with reserve ratio experienve rating laws do not permit such payments. They are: California, District of Columbia, Georgia, Idaho, Louisiana, Massachusetts, Nevada, New Hampshire, New Mexico, New York, Tennessee.

It is to be hoped that these states will give early consideration to the "case for voluntary contributions." ☆

Miscellaneous new decisions this month

Operating a company town a mining activity for percentage depletion; transporting ore a non-mining activity. Taxpayer, operator of a gilsonite mine, sold 90% of its product in the fine and select grades and pulverized the remaining 10% in order to reach a special market. The court holds that pulverizing and sacking the gilsonite were just as much part of the ordinary treatment processes for purposes of computing percentage depletion as the sorting and sizing into the fine and select grades. Similarly, the costs incurred in maintaining a town of homes rented to employees near the mine to attract a labor supply are held to be production costs for the depletion computation. The cost, however, of transporting the ore a distance of over 50 miles from the mine to the sacking plant, and the maintenance of an office there, are considered costs beyond mining. *American Gilsonite Co.*, 27 TC No. 22.

Bond interest and premium expense allocated between mining and non-mining income. The Code provides for a coal depletion allowance of 10% of the gross income realized from coal properties provided the allowance does not exceed 50% of the net income from the properties. The question here presented is whether premiums paid by taxpayer, a coal company, on repurchase of its bonds and interest paid on the outstanding bonds must be allocated between income from mining operations and other income in computing the 50% of net income limitation. The court agrees with the Commissioner that the payments cannot be deducted from income solely attributable to nonmining activities but must be properly allocated. *St. Louis, Rocky Mt. and Pacific Co.*, 28 TC No. 5.

Bank fails to meet requirements of special relief provision. In 1938 Congress passed a special relief provision designed to prevent the Government collecting taxes at the expense of depositors whose claims had not been paid off during the depression. The statute provided that, where the depositors were given a lien on earnings or a preference against assets, no tax would be collected which would deplete the funds available for the payment of their claims. In 1933 taxpayer-bank gave its depositors deferred certificates for the amount of their deposits, payable out of future earnings and as the funds were released by the Illinois Auditor of Public Accounts. Since these certificates carried no lien, the requirements of the relief statute were not met. The court also finds that the payment of taxes in the year at issue would not deplete the fund for payment of the certificates. *DeKalb Trust & Savings Bank*, DC Ill., 2/11/57.

Mutual insurance companies with guaranty funds still classified as "mutual." Taxpayer, a mutual fire insurance company, had borrowed money for which it issued certificates promising a cumulative fixed return and repayment of principal out of surplus only. Certificate holders could vote. The court holds that the existence of such a guaranty fund certificate alone does not make a mutual fire insurance company a stock company under Section 204 of the 1939 Code rather than a mutual company under Section 207. Nor is the fact that a mutual company with guaranty fund certificates outstanding has accumulated large reserves to provide its policyholders reasonable protection against loss sufficient to change its tax classification from a mutual to a stock company. *Property Owners Mutual Insurance Co.*, 28 TC No. 116. Similarly *Citizens Fund Mutual Fire Insurance Co.*, 28 TC No. 117.

One-half of "overplus" from sale of security crop by CCC income when received. Certain farmers' marketing cooperatives, though "exempt from tax,"

are taxed on income in the ordinary way but are allowed to deduct patronage dividends. The IRS outlines the treatment of Commodity Credit Corporation loans in determining the income of the cooperative. Prior to 1955 loans on each year's crop were separate and if the commodity were sold for more than the loan, the "overplus" would be paid to the cooperative. Currently, however, only one-half of the overplus is repaid; the balance may be held as additional security for CCC loans on other crop years. The IRS rules that the cooperative must report the half paid over as income in the year received. The other half of the overplus, retained by the Commodity Credit Corporation, is not income until the excess, if any, over the cooperative's outstanding indebtedness is determined. *Rev. Rul.* 57-358.

Farm rent income counts for social security. The Service explains the type of farm rent income which counts for social security. The owner must take part in production or management. Specifically, he must fit three of four tests: furnish equipment; meet costs; periodically advise, or periodically inspect. *Spec. Rul.* 3/20/57.

Revocation of 710(a)(5) election doesn't cancel benefit retroactively. Section 710 (a) (5) of the 1939 Code permitted taxpayers to defer payment of part of the excess profits tax they claimed was excessive under Section 722. Taxpayer so deferred tax and interest accrued to date. In 1945, it paid the deferred tax and interest accrued to date. It appears that taxpayer knew the Commissioner had ruled that such interest was deductible when paid and taxpayer wanted the deduction then, the last year of wartime taxes, and that it was willing to pay income tax on its refund if it obtained the Section 722 relief requested. Taxpayer was granted 722 relief. But the Commissioner refused to refund any part of the interest on the ground that because of the 1945 revocation of the election under Section 710(a)(5), the taxpayer must be treated as if it had never made an election and therefore interest was due when the delayed 1942 excess profits tax payment was made in 1945. The Commissioner conceded that had the taxpayer not revoked the election in 1945 no interest would have been due on the deferred tax eliminated under Section 722. The court holds for the taxpayer; it was entitled to the benefit of Section 710(a) (5) while the election was outstanding. The time has expired for assessing interest on the income due for the period 1942 to 1945 because of the Section 722 reduction in excess profits tax. The court holds the Government is entitled to a setoff by way of recoupment for this interest. The income tax interest payable by the taxpayer and the excess profits interest refund here decided to be due arose out of the same transaction. *E. I. du Pont,* Ct. Cls., 1/16/57.

722 claim doesn't open other issues otherwise barred by statute. [*Non-acquiescence*]. Commissioner here assessed additional tax after the year was closed unless it had been opened by a pending 722 case. The Commissioner argued that when taxpayer filed a petition based on 722 with the Tax Court he asked for a redetermination of tax and therefore all issues in that year are open. The Tax Court held that while some language in the Committee Reports might support that view, such an interpretation is too great a change to be accepted without clear statutory authority. *Poe Mfg.,* 25 TC 691, *non-acq.,* IRB 1957-17.

Adjustments to base period 1951 excess profits tax. This court finds the Tax Court erred in not removing from the base period income taxpayer's losses on its camera division. This was a separate branch even though it was only 600 feet from the artillery fuse plant. The statute defines branch as separate but does not require a substantial geographical distance. However, it was proper to remove a bad debt arising from the sale of a new product business. Taxpayer sold a part of its business at a separate location and didn't receive payment. There was no change in the business as defined in the statute; hence this loss was not the consequence of a change and the loss can be added back. Finally, the Treasury properly computed the disallowance limited to the excess over 115% of the average of such deductions and to the excess over 5% of average net income. *Collins,* CA-8, 4/29/57.

Relief under Section 722(b)(1) and (2) must be predicated upon an external event. The closing down of a shoe corporation during the base period because of an internal reorganization of management and policy is held not to be such an external event beyond the corporation's control as would qualify it for EPT relief under Section 722(b)(1), (2). *Pied Piper Shoe Co.,* 28 TC No. 54.

Foundation engaged in construction business exempt; funds used charitably (Old Law). An individual operated a masonry business through three entities: partnership, corporation and foundation. was set up to aid needy students, and certain contracts were taken in the foundation name. The district court held the foundation taxable. This court reverses. The years involved were 1949, 1950 and 1951, prior to the change in the law taxing unrelated business income of certain exempt institutions. Some circuit courts had interpreted the prior law as denying exemption if business activities were so important as to make charity not the "exclusive" purpose. However, at the time this foundation was organized the destination test, laid down by the Supreme Court, was being followed exclusively. This court follows the destination rule and finds this foundation exempt. *Lichter Foundation,* CA-6, 8/30/57.

Charitable deduction allowed for contribution of "air rights" [*Acquiescence*]. Owners of a lot with a two-story building thereon conveyed to a charity the perpetual rights to build, own, and maintain five additional stories on the existing building. Although the owners did not obligate themselves to rebuild in case of destruction of the building, if they did elect to rebuild, the charity would also have the right to rebuild. The court holds the conveyance of the "air rights" constituted valuable property rights which qualified as a charitable contribution, and finds the value of such rights at not less than $70,000. An alternative claim made by the Commissioner that the basis of the two-story building should be decreased by any value determined for the 'air rights" is ruled improper as the Commissioner did not contest the depreciation taken on the two-story building, and did not offer any other reason for requesting the reduction in basis. *Fair,* 27 TC 866, *acq.* IRB 1957-29.

Contributions to Brussels' World's Fair deductible. Amounts contributed to the Office of the U. S. Commissioner General, Brussels Universal & International Exhibition, 1958, are deductible as contributions or gifts to or for the use of the U. S. for exclusive public purposes. *Rev. Rul.* 57-432.

NEW DEVELOPMENTS IN
Tax policy & legislation
FOR PRACTITIONERS

Our tax policy is based on obsolete theory; new approach is needed

by **WILLIAM D. ROSS**

The originally shocking idea that the budget need not, indeed should not, be balanced in every year has become the generally accepted theory. The budget, it is now agreed by legislators, Treasury officials and the general public, should be used to stabilize the economy by working against the business cycle. But now that this theory has won wide acceptance, some economists are beginning to warn that the Keynesian "counter-cyclical" management of government spending is no longer valid. Dr. Ross here clarifies this shift in viewpoint for the alert tax man planning for the years ahead.

CAREFUL EXAMINATION of the American economy at the moment reveals some rather startling transformations, changes which suggest the need for a re-evaluation of both the conventional finance approach and the fiscal policy approach to governmental taxation, expenditures and debt management.

The foundation of fiscal policy, as the concept is understood by economists today, rests upon Keynes' concept of the propensity to consume. Keynes states: "The fundamental psychological law, upon which we are entitled to depend with great confidence both a priori from our knowledge of human nature and from the detailed facts of experience, is that men are disposed, as a rule and on the average, to increase their consumption as their income increases, but not by as much as the increase in their income."[1]

This, according to Keynes, necessitates a rising rate of investment spending to keep pace with savings and maintain stability in the economy. Declining rates of population increase, of new technological discovery, etc., were cited by Keynes and his followers as reasons for not expecting this to happen; the result was believed to be a secular tendency toward instability and depression in the economy. This situation, Keynes concluded, called for monetary and fiscal action by government to correct the imbalance, maintain stability and assure a satisfactory level of employment in the economy.

In the period since World War II, virtually all occupational and political groups in the United States have come to accept Keynes' fiscal policy approach to the problem of economic stability. The Keynesian conquest is now complete, as clearly evidenced by the policies of the current Republican administration.[2]

Ironically, this conquest may have occurred at precisely the moment at which Keynes' specific concepts and analyses ceased to be applicable.

It is the suggestion of this paper that it is an observable fact that the economic conditions, the cultural patterns, the social group relationships and the psychological attitudes that exist in this nation today are not the same that existed in the period observed and analyzed by Keynes. The psychological law has changed, and the implications of this change for public finance policies and practices are tremendous and far reaching.

The cornerstone of existing fiscal policy theory, the stable propensity to consume, is no longer an accurate or applicable concept. Instead, the U. S. economy of 1957 is characterized by an *unstable propensity to consume* in the upward direction. This is a fundamental and permanent change in the economic, social and cultural life of the nation. The change is a result of a fundamental change in the institutional structure of our society and of a general weakening or virtual elimination of some of the main motives which, as analyzed by Keynes, led individuals to refrain from spending out of their incomes in past periods. The factors which have caused this change are multiple, varied and complex. They include the welfare state philosophy of the New Deal, which itself was based in large part upon Keynesian fiscal policy concepts; the influence of the philosopher, John Dewey, upon education, psychology and social relationships in general in the United States; the unstabilizing and innovating influences of modern total warfare upon social and cultural patterns, as evidenced by increasing marriage rates, increasing birth rates, and the lower average age of marriage; and, finally, the application of modern promotional techniques through mass media of communication to the task of securing expansion and social acceptance of consumer credit.

Today, the typical American family proceeds without hesitation to mortgage its future for a period of twenty to thirty years for a new home; to purchase furniture, home appliances of all types, and a new automobile on installment credit; and to have two to five children with little real concern for the educational and other advantages they

[1] J. M. Keynes, *The General Theory of Employment Interest and Money*, New York, 1936.

[2] The following is a typical statement of current Federal policy with regard to economic stabilization:

"Federal tax policy should recognize that the level of tax revenues in relation to the amount of government expenditures has an important bearing on the level of economic activity. This would tend to result in Federal surpluses and debt retirement during prosperous and boom periods and deficits during recessions and depressions.

"In recent years there has been increasing understanding of the fact that the Federal Government's tax and spending programs are important factors affecting levels of economic activity. It is now generally recognized that, given the amount of Government spending, Federal fiscal policies have a significant impact on the total demand for the goods and services which can be produced by maximum employment of our resources, and that, therefore, an important objective of these policies must be to minimize fluctuations in the level of total economic activity. Such fluctuations represent significant barriers to the attainment of any long-run growth objectives; recessionary movements interrupt the process of growth by leaving some of our growing resources idle, while inflationary changes in economic activity make continued growth more difficult to maintain." Federal Tax Policy for Economic Growth and Stability, Report of the Joint Committee on the Economic Report, 84th Congress, Second Session, Senate Report No. 1310.

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may or may not be able to make available to their offspring. As soon as a portion of their mortgage and installment credit obligation is liquidated, they are ready for air conditioning units, outboard boats, motors and trailers, and back yard patios and swimming pools to go with their television sets, electric dishwashers and other modern luxuries. They are a ready market for new and better gadgets at all times. Their saving takes the form of accumulation of equity in homes and durable consumer goods resulting from mortgage and installment credit payments.

Consciousness of security

Although there is still a great deal of public discussion of the problem of economic security for the individual family, the actions of the individual family belie this concern. The typical American family has become aware, although perhaps subconsciously, of the existence of a high degree of security in the U. S. economy today. There is no need to build up the reserve against unforeseen contingencies, about which Keynes spoke; institutional bulwarks against such contingencies have been provided for the family in the form of old age and survivors insurance, unemployment insurance, workmen's compensation, group life insurance, group medical insurance, group saving plans and a host of other so-called fringe benefits.

The desire to enjoy larger real consumption at a later date through smaller immediate consumption and the accumulation of interest and appreciation on current savings has been almost completely undermined by the spectacular postwar development in consumer and installment credit. The process has been reversed; the practice today is to enjoy the larger consumption now and do the saving later.

Increase in expenditures

There are still some individuals who are motivated by what Keynes called "unreasonable but insistent inhibitions against acts of expenditure as such or pure miserliness," but there are almost no such individuals today under the age of forty, and the economic, social and political conditioning which the children and youth of today are receiving virtually assures the future elimination of such people and of such attitudes. Rising family incomes today call forth expenditures for better and bigger homes, automobiles and gadgets, rather than increased individual savings in past conventional forms.

War and postwar Federal personal and corporate income tax laws, the progressive rate structure of these taxes, and the complex, discriminatory and capricious administration of these taxes have been another important influence in the transformation of the saving and spending habits of the American family.

Nature of savings changed

The importance, nature and motivations of governmental, institutional and business saving have also changed significantly. The motivation is different for the farmer who produces his crops on governmentally guaranteed farm credit under governmental crop control regulations. The number of small businesses, proprietorships, partnerships, and small corporations, has not kept pace with the increase in the population and the labor force so that these business savers are less important in the economy today than in the past. Professional managers of the nation's large corporations are not motivated in exactly the same fashion as the owner-managers of the past. Attitudes toward external debt and equity financing have been influenced by the tax structure and by the changing position of corporate managers. Retained corporate earnings have been subjected to statutory control not known in the past.

These complex and varied changes that have occurred in the economy since 1940, and with accelerated rapidity and final fruition only within the past five years, would seem to supply the explanation of many recent economic phenomena. They would seem to explain decreasing ratios of savings of individuals in the conventional forms of bank savings accounts, savings and loan association share accounts, etc., and the significantly increased withdrawal or turnover rates of such conventional savings—the latter development indicating the short-term nature of such savings which are associated in an ever larger number of cases with short-term down payment accumulation for the purchase of major durable consumer goods, such as housing and automobiles. They explain the tremendous expansion that has occurred in institutional saving and investing, particularly through insurance companies and trust funds. Above all, they would seem to explain the phenomena of continued prosperity, full employment and expanding national production in this country, coincident with relatively stable rates of private investment and of governmental expenditure. There would seem to be only one explanation for this development: with each new year and each expansion in the national income, the propensity to consume is shifting upward. The very slope of the consumption expenditure curve in recent years gives some evidence of this development.

Is this a permanent change in the basic structure of the economy? There is every reason to believe that it is both basic and permanent.[3]

Implications for public finance

What are the implications of this change for public finance? First, it means the end of counter-cyclical fiscal policy in Keynesian or neo-Keynesian terms; it means the end of the budget-deficit-budget-surplus approach to fiscal policy. It means the end of the deflation-depression aspect of the economic stablization problem. On the other hand, it signifies an increase in the magnitude of the inflation control problem. It adds a new and fundamental economic element which is predominately inflationary, the unstable propensity to consume, to the predominately inflationary socio-political element, the danger of monopoly-impelled price-wage spirals.

This analysis suggests that the following steps are needed at once: (1) Immediate Federal action to secure and maintain complete and current statistics on the financial activities of all units of government in this nation. Such data are as important to intelligent public policy today as national income, consumer price, production, and other important economic data. (2) A reappraisal of all government expenditure programs at all levels of government. (3) A reappraisal of tax structures at all levels of government. (4) Coordination of new tax and expenditure decisions at the Federal, state and local levels of government.

On the expenditure side, this analysis suggests an end to public works planning

[3] It is obvious that the ramifications of this development, if this analysis is correct, are not limited to public finance but will affect every aspect of the economic and social life of this Nation.

[4] William D. Ross, *Financing Highway Improvements in Louisiana*, Baton Rouge, Louisiana, 1955, p. 18.

for purely counter-cyclical fiscal policy purposes. It means that public expenditures for public works and other purposes must be justified on their own merits. It means that the regular operating expenditures of government and public works expenditures by government must be measured by the criterion of their contribution to economic growth in the economy. It means that the financing and timing of such expenditures must be measured in terms of the inflation control criterion. Government functions and government expenditures, which are essential to economic expansion in the economy, such as highway improvements and expanded and improved schools, cannot be deferred to periods of deflation and recession, if no such periods are to reoccur; nor can such expenditures be deferred because they create inflationary pressure. To delay such necessary public improvements would create disastrous bottlenecks in the expansion of the entire economy and the standard of living of the nation.

For tax policy at all levels of government, this analysis, if it is correct, would seem to suggest the more extensive use of consumption-repressive luxury excise taxes on commodities and services, as a means of controlling inflationary pressures and of assuring an adequate flow of resources into private investment in new plant and equipment and into public investment in essential public works and national defense.

Depression no threat

If depression is no longer a threat, a much-needed rationalization of the Federal income tax structure would also be feasible. It has been prohibited by concern both as to the influence of such a move upon effective demand and upon business incentives. Such action could add greater equity and integrity to the entire tax structure and improve its efficacy for inflation control. Many uneconomic tax-motivated distortions in the current operations of private business firms could, thereby, be eliminated, increasing significantly the efficiency of the entire economy.

Possible debt policy

For debt policy, this analysis suggests the use of governmental debt management as an anti-inflation weapon. It suggests the possibility of gradually and permanently reducing governmental debts in the economy. This, however, is the long-term over-all implication. In cases involving the financing of major capital expenditures such as the construction of highways, bond financing may be the soundest approach that can be used. It will frequently be the only means of securing the needed improvements in a reasonable time and of facilitating the growth of our economy.[4]

Self-generating equilibrium

Finally, this analysis suggests that there has developed in modern American capitalism a self-generated equilibrating mechanism which gives the system great economic stability, as well as the drive of harnessed individual human initiative. This has important implications for the role of government in this new and improved brand of capitalism, to which we have apparently fallen heir. The *new economics of capitalism suggested in this paper* implies a limited and easily controlled role for government in the economic system, rather than the Leviathan of neo-Keynesian counter-cyclical fiscal policy economics.

CED inquiry suggests broad study of taxation?

ANNOUNCEMENT by the Committee for Economic Development that it will undertake a three-year inquiry into the public and private monetary and credit policies of the U.S. raises the question of whether anyone is ever going to take action on the oft-made proposals that we need a very broad-guage, independent study of taxation and its affect.

The CED study just announced will be supported by a grant of $500,000 from the Ford Foundation. The Commission to be appointed from among the country's leading experts in this area, will operate independently of the CED, Ford Foundation, or the government.

It strikes us that this is exactly the kind of approach needed to find out about how our tax system affects us. Taxation ranks with monetary and credit policies as a major determinent of economic health. Taxation is among the most influential forces in many areas of society, and certainly in management of the government.

We'd like to suggest to CED that it consider, at the proper time, the sponsorship of a really definitive study looking to a better understanding of what taxation really is doing to us. ☆

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Klein's conviction for conspiracy upheld; used multiple foreign corporations. Defendants used a syndicate of foreign and domestic corporations so that profits on sales of whisky in the U. S. during World War II accumulated free of U. S. tax in a foreign corporation, which was subsequently liquidated at a capital gain to the American stockholder. The district court held that the question of whether these corporations were sham or carried on some business activity involves a complex issue of law and is not for the jury to decide. It thereafter dismissed four counts charging evasion. Where, however, certain payments made by one of the corporations were given inconsistent treatment by the corporation and by the various defendants, the court finds a question for the jury on the existence or nonexistence of a conspiracy to defraud the U. S. by impeding and obstructing the functions of the Treasury Department. The jury found them guilty. This court affirms. While the conspiracy charge was broadly stated, and the prosecution and the court carefully avoided adopting any one of the various theories of the nature of the payments, the defficulties arose at bottom out of the complexity of the facts, as deliberately arranged by the defendants. Of this, they cannot now complain. The judge's charge to the jury was also, this court states, very skillful. "The ultimate fact was simple and the judge succeeded in keeping it from being concealed by the multitudinous details . . . In summary we find that defendants had a rigorously fair trial. . . . The convictions were amply justified. Here tremendous American profits were skillfully concealed from the collector's eyes until they were uncovered by this patient investigation and trial. The result should be salutary." *Klein*, CA-2, 9/3/57.

Omissions on returns not fraudulent; some errors favored government. Taxpayer operated a wholesale seafood business as a sole proprietor. At the same time he was a member of several joint ventures which planted and harvested oysters, and of other ventures which processed them. After processing, all the oysters were marketed by the proprietorship. Because of the inadequacy of the accounting system with reference to the inter-business transactions, taxpayer failed to include any of the joint venture income on his individual returns. The court notes that the accounting method which taxpayer employed did not result in a consistent pattern of understated income for all years. There was a substantial overreporting of income for one year. It finds taxpayer's returns were not fraudulent and assessments for some of the years were therefore barred by the statute of limitations. *Smith*, TCM 1957-171.

Agent, examining partners about links with third party, not deceptive in concealing assignment to examine partnership. Two partners were indicted for attempting tax evasion by making false statements to an agent. They move to have the allegedly false statements suppressed on the ground that they were improperly obtained. The court finds that the agent, though, it says, he was under no duty to do so, warned them of their right to refuse to give information which might incriminate them. They further claimed that the affidavits were inadmissible because they were obtained by fraud in that the agent deceived them by saying the investigation was concerned only with another firm. The court finds that although the agent (a Special Agent) had been assigned these partners for investigation he had not begun that job and was in truth actively engaged only in the examination of the other firm. Thus there was no deception and the affidavits must be admitted as evidence. It appears from the facts that the agent had three checks of the other firm, drawn to this partnership and cashed through a check-cashing agency. He asked to see the accounts receivable records of the partnership for the period involved. [Though the opinion does not make it clear whether the receipts appeared on the books or what the affidavit said, the inference from the indictment that they made false affidavits for the purpose of concealing income is that the books did not show the checks and the affidavits denied knowledge of them.—*Ed.*] *Eitingin*, DC, N. Y.

Reconstruction of income by net worth. Taxpayer engaged in varied and numerous business activities and investments but failed to keep adequate records. His business transactions were almost entirely cash transactions. The court accepts a reconstruction of his taxable income for 1944-1950 by the net worth method. It finds no error in determining his income by first combining his assets and liabilities with that of his wife to arrive at a combined gross income, and then deducting the gross income which had been shown on the wife's separate return. The court also finds "clear and convincing evidence" of a fraudulent intent to evade taxes in the substantial understatements coupled with the failure to keep proper records, the destruction prior to the hearing of such records as were kept, the almost exclusive dealing in cash, and in some instances the carrying out of transactions through bank accounts in the names of others. *Polizzi*, TCM 1957-159.

Gambler's income reconstructed. Taxpayer, a professional gambler, although conceding that use of the net worth method for reconstructing his income was proper, contended that as of 12/31/47 he had accumulated, in addition to the assets shown in the net worth statement, approximately $138,000 in cash. He further alleged that substantial investments over the period 1948 to 1951 were made from the cash on hand rather than from current taxable earnings. The court applying the *Cohan* rule finds that the taxpayer had cash on hand as of 12/31/47 in the amount of $55,000. It redetermines the deficiency for 1948 but approves in full the deficiencies for 1949 through 1951, together with the fraud penalties for all years. *Silver*, TCM 1957-181.

Doctor's conviction for tax evasion upheld [*Certiorari denied*]. Taxpayer, a doctor, was found guilty of tax evasion by a jury. On appeal, the Third Circuit held that there was sufficient evidence of the doctor's refusal to cooperate in keeping, localizing and producing records

for the jury to find wilfulness. *Litman, cert. den.* 11/12/57.

Use of bank deposit method on gambler sustained. Although taxpayer reported gross income of $14,500, he made bank deposits during that same year of some $37,000. Based on these deposits, the Commissioner determined large amounts of unreported income. The facts showed that taxpayer had been betting on race horses with substantial frequency and kept no records of these transactions. The court rules that the Commissioner properly used the bank deposit method to construct taxpayer's income. *Romer,* 28 TC No. 145.

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